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The ninth edition of *The Private Equity Review* follows another extremely active year for dealmakers in 2019. While the number and value of global private equity deals completed declined slightly from 2018, deal activity was still robust, weighted towards the upper end of the market, and included several large take-private transactions. Fundraising activity was also strong with aggregate capital raised just slightly below 2018’s record levels, as institutional investors remained extremely interested in private equity as an asset class because of its continued strong performance. That, combined with some caution due to an uncertain market environment, has resulted in private equity funds having significant amounts of available capital, or dry powder. This dry powder, together with competition from non-traditional dealmakers, such as sovereign wealth funds, family offices and pension funds, led to very competitive transactions being completed at increasing purchase price multiples. This has caused private equity firms to become even more creative as they seek opportunities in less competitive markets or in industries where they have unique expertise. Given private equity funds’ dry powder and creativity, we expect private equity will continue to play an important role in global financial markets, not only in North America and western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. In addition, we expect the trend of incumbent private equity firms and new players expanding into new and less established geographical markets to continue.

While there are potential headwinds – including trade tensions, the upcoming US election and an eventual end to one of the longest-running recoveries in US history – on the horizon for 2020 and beyond, we are confident that private equity will continue to play an important role in the global economy, and is likely to further expand its reach and influence.

Private equity professionals need practical and informed guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. *The Private Equity Review* has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 22 different countries, with observations and advice on private equity dealmaking and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.
I want to thank everyone who contributed their time and labour to making this ninth edition of *The Private Equity Review* possible. Each of these contributors is a leader in their respective markets, so I appreciate that they have used their valuable and scarce time to share their expertise.

**Stephen L Ritchie**  
Kirkland & Ellis LLP  
Chicago, Illinois  
March 2020
Part I

FUNDRAISING
Chapter 1

AUSTRIA

Martin Abram and Clemens Philipp Schindler

I GENERAL OVERVIEW

At the time of writing, no information was available about the fundraising market in 2019. The most recent information available is for 2018, for which the Austrian Venture Capital Association reported that Austrian private equity and venture capital funds raised €160 million, compared with €216 million in 2017 and €10 million in 2016.

The number and volume of Austrian private equity and venture capital funds continues to be well below the European average.

Following general elections in 2019, a new Austrian government took office in January 2020 and announced its intention to implement a programme to provide incentives for private equity investment into start-ups and small and medium-sized enterprises (SMEs), which includes potential tax incentives as well as a new corporate form (akin to a Luxembourg SICAV) for alternative investment funds (AIFs). It still remains to be seen if, and to what extent, this programme will be implemented.

II LEGAL FRAMEWORK FOR FUNDRAISING

Since the introduction of the Alternative Investment Manager Act (AIFMG), which implements the Alternative Investment Fund Managers Directive, most private equity funds established in Austria will qualify as AIFs under the AIFMG. An AIF is defined as a collective investment undertaking that raises capital from a number of investors to invest it in accordance with a defined investment policy for the benefit of those investors, and that does not use the capital for direct operational purposes. Funds pursuant to the Austrian Investment Funds Act as well as funds qualifying under the Austrian Real Estate Investment Funds Act are not captured by the AIFMG.

The formation of an AIF requires the prior approval of the Austrian Financial Market Authority (FMA) if the fund is managed by a licensed alternative investment fund manager (AIFM). If the fund is managed by a registered AIFM, it only has to be registered with the FMA. AIFMs must obtain a licence if they manage funds with assets of more than €100 million (where leverage is used) or more than €500 million (where no leverage is used); otherwise, only a registration is required.

1 Martin Abram and Clemens Philipp Schindler are partners at Schindler Attorneys.
To obtain a licence under the AIFMG, the manager must fulfil the following requirements.

a. A licensed AIFM must have minimum capital of €125,000 if it is an external manager of an AIF. If the AIFM is an internal manager of an AIF, the minimum capital requirement is €300,000. In addition, the AIFM must have sufficient equity to cover 25 per cent of its annual running costs. Increased equity requirements apply if the assets under management exceed €250 million; in any case, the maximum capital requirement is €10 million. The persons tasked with the management of the AIFM must be sufficiently experienced, and have to pass a ‘fit-and-proper’ test if so requested by the FMA.

b. The AIFM has to appoint at least two individual persons as its managers.

c. In the application to the FMA, the AIFM must provide information on shareholders holding qualified participations in the AIFM (i.e., shareholdings exceeding 10 per cent), on any closely related entities (i.e., a third party that holds a stake of more than 20 per cent of the AIFM or that controls the AIFM, or is controlled by the AIFM or in which the AIFM holds a stake of more than 20 per cent), its business plan, its remuneration, risk management, valuation, internal audit and conflict of interest policies, its investment strategies, a description of any competences delegated to third parties and information on the contractual basis pursuant to which it manages its AIFs.

The decision of the FMA regarding the licensing of an AIFM has to be made within three months of the applicant providing all required information. If the AIFM intends to register an AIF as a European long-term investment fund (ELTIF) (see Section II.vi), he or she has to apply to the FMA for prior approval.

i Vehicles used for private equity funds

The main vehicles used for private equity funds established in Austria are limited partnerships (LPs), typically with a corporation as the general partner, or corporations, namely limited liability companies (LLCs) and joint-stock companies (JSCs). Each of these types of entity has a separate legal personality, but partnerships are transparent for tax purposes.

LPs

Typically, investors become limited partners in an LP. The general partner is usually an LLC that receives a fee for assuming unlimited liability. In some structures, the general partner manages the partnership; in other structures, a separate management company (usually an LLC) manages the partnership. As private equity funds in most cases fall under the AIFMG, the entity managing the fund must be a legal person licensed or registered as an AIFM under the AIFMG. There are generally no minimum capital requirements for newly incorporated LPs.

Corporations

Investors become shareholders in an LLC or a JSC. An LLC is managed by a managing director, a JSC by a managing board. JSCs (as opposed to LLCs) are required by law to also have a supervisory board. Managing directors, as well as members of the managing board, have to be natural persons. However, as with LPs, corporations can outsource management
functions to a management company, which in most cases must be licensed or registered as an AIFM under the AIFMG. Austrian law has minimum share capital requirements for LLCs (€35,000, or €10,000 in the case of a privileged incorporation) and JSCs (€70,000).

In the past, sponsors also structured vehicles in the form of LLCs or JSCs as a medium-sized business financing company (MFG) under the Corporate Income Tax Act (KStG), as this gave rise to several tax benefits. MFGs had to fulfil certain requirements, such as higher capitalisation, participation of public bodies and certain investment restrictions. As those tax benefits no longer apply for vehicles founded after 2012, and ceased to apply in respect of participations held by existing MFGs (founded before 2012) by the end of 2015 (in special circumstances, by the end of 2018), the importance of the MFG has decreased significantly. The tax benefits for MFGs were reintroduced in 2017; however, only to a limited extent. In particular, the tax benefits only apply for minority investments in early stage enterprises.

ii Key legal terms

In addition to terms imposed by mandatory provisions of Austrian law, in particular the investor protection provisions of the AIFMG for private equity funds classified as AIFs, the key terms of the relationship between the investor and the fund are governed by the partnership agreement (for LPs) or the articles of association and shareholders’ agreements (for LLCs and JSCs). Terms of a private equity fund typically subject to negotiation include:

a investment restrictions, such as target size, concentration limits, geographic limitations, diversification of industries, limits on borrowing and related-party transaction restrictions;

b limitations on the fund’s size and the investors’ capital commitments;

c investment period;

d key-man provisions;

e provisions permitting the removal of the manager by a qualified majority of investors;

f remuneration of the manager (i.e., management fee, investment-related fees and carried interest);

g reinvestments; and

h exclusivity.

iii Disclosure of information

In recent years, Austria has seen an increasing number of court proceedings by private investors against managers and promoters of funds to recover losses suffered during the financial crises. These proceedings highlight the importance of full disclosure to investors at the time they invest in a fund.

Managers of funds have to ensure that all documents given to investors, in particular the offering documentation and all advertising material, disclose all facts and circumstances relevant to prospective investors fully and correctly. Additionally, special care should be taken that any opinions and plans disclosed to investors are reasonable and based on verifiable facts. Special care must also be taken to ensure that the wording of documents is not too complicated or technical, otherwise there is a risk that this could be seen as insufficient disclosure. Austrian courts do, by and large, take into account the types of investors to which such offering documentation is addressed, and may take a less restrictive position in cases where an offer is solely addressed to institutional investors (as opposed to offers addressed to retail investors).
In the case of insufficient disclosure, managers are faced primarily with damage claims, rescission claims, or a combination of both by investors; additionally, regulatory sanctions and – in extreme cases – criminal sanctions may apply.

The key items for disclosure vary depending on whether the offer of the fund interest falls under the scope of the Austrian Capital Markets Act (in which case a prospectus conforming to the EU prospectus regime has to be published). Typically, the main items for disclosure are:

- investment strategy;
- market overview and regulatory environment;
- key terms of the investment (see above);
- risk factors;
- track record of the manager and its executives; and
- tax matters.

If the offer of interests in a private equity fund falls under the scope of the Austrian Capital Markets Act (and no private placement exemption applies), the issuer has to prepare a prospectus, which complies with the EU prospectus regime, except for (1) offers encompassing fund interests with a total value of less than €5 million during a 12-month period, in which case a simplified prospectus can be used, and (2) offers encompassing fund interests of LPs, in which case the prospectus regime of the Austrian Capital Markets Act has to be used. In this case, additional disclosure requirements apply.

iv Solicitation

The method of solicitation is mainly influenced by regulatory constraints. Most commonly, solicitation is made by way of an information or offering memorandum. Potential key investors are typically contacted at an early stage to gauge their initial interest. Unless there are regulatory constraints (such as in the case of public offers falling under the scope of the Austrian Capital Markets Act), investors are invited to follow-up meetings or given the opportunity for a limited due diligence. Depending on the size of the fundraising, managers may also appoint third-party promoters to assist in identifying potential investors; also in addition, outside counsel is retained to prepare the documentation for the fundraising.

Limitations on solicitation

Offers and sales of interests in private equity funds formed in Austria are subject to the following selling restrictions, which depend on the category of the private equity fund.

For AIFs managed by a licensed AIFM:

- interests in the fund may only be offered or sold after the AIF is approved by the FMA; and
- interests in the fund may be offered or sold to private investors, if the prerequisites of Sections 48 and 49 AIFMG are met, except if the fund is registered (1) as a European venture capital fund (EuVECA) (see Section II.v); in this case, it may be offered to private investors subject to certain restrictions (in particular, a minimum investment commitment of €100,000 and a written acknowledgment of the risks associated with the investment by the private investor) or (2) as an ELTIF (see Section II.vi); in this case, it may be offered to private investors subject to certain restrictions (in particular, an offer is only possible to private investors having an investment portfolio of at least €100,000 after the investor has received appropriate investment advice).
For AIFs managed by a registered AIFM:

a. interests in the fund may only be offered after the AIF was notified to the FMA; and

b. interests in the fund may not be offered or sold to private investors, except if the fund is registered as an EuVECA; in this case, it may be offered to private investors subject to certain restrictions (in particular, a minimum investment commitment of €100,000 and a written acknowledgment of the risks associated with the investment by the private investor). No ELTIF registration is available for funds managed by registered AIFMs.

For private equity funds falling outside the AIFMG:

a. any public offer of interests in private equity funds falling outside the AIFMG requires the publication or approval, or both, of a prospectus by the FMA, unless a private placement exemption applies;

b. the private placement exemption applies, in particular, for offers to qualified investors only, offers with a minimum investment amount of €100,000, and offers to fewer than 150 investors; and

c. even if the private placement exemption applies, the intended offer has to be notified to the issue register maintained by Oesterreichische Kontrollbank AG.

v. EuVECA Regulation

The EuVECA Regulation\(^3\) was introduced to create a new pan-European designation for small AIFMs, the EuVECA. Austria-based AIFMs may register an AIF as a EuVECA provided that they comply with the EuVECA Regulation and have supplied certain information with regard to themselves and the relevant AIF to the FMA. The main advantage the AIFM gains by doing so is the option to market the relevant AIF throughout the EU under the EuVECA designation to certain categories of investors defined in the EuVECA Regulation under an EU-wide passporting regime. Passporting allows a firm authorised under an EU single market directive to market the designated fund to certain qualified investors in another EU Member State, on the basis of its home state authorisation.

The EuVECA Regulation is not compulsory; if an AIFM does not want to use the EuVECA designation, then it does not have to comply with the EuVECA Regulation for a particular fund (or at all). If the AIFM chooses not to use the EuVECA designation, national laws and EU regulations apply, such as national private placement regimes.

vi. ELTIF Regulation

The ELTIF Regulation\(^4\) was introduced in November 2015 to channel capital raised through AIFs towards European long-term investments in the real economy. Austria-based AIFMs who have received approval to manage ELTIFs may register an EU-based AIF (or a compartment thereof) as an ELTIF, provided that they comply with the authorisation requirements set out in the ELTIF Regulation and submit an application to the FMA. The main advantage of such a registration is the option to market the relevant AIF throughout the EU under an EU-wide passporting regime similar to the regime under the EuVECA Regulation. Additionally, the designation of an AIF as an ELTIF allows its marketing to high-net-worth individuals throughout the EU.

\(^3\) Regulation (EU) No. 345/2013 on European venture capital funds.

The ELTIF Regulation is not compulsory; if an AIFM does not want to use the ELTIF designation, it does not have to comply with the ELTIF Regulation for a particular fund (or at all). If the AIFM chooses not to use the ELTIF designation, national laws and EU regulations, such as national private placement regimes, apply.

**vii Fiduciary duties to the investors**

Typically, the scope of the sponsor’s fiduciary duties is determined by the AIFMG (which most private equity funds fall under), the constitutional documents of the fund vehicle (supplemented by pertinent rules of law) and other contractual arrangements (if any).

Under the AIFMG, the manager has, inter alia, to act in the best interests of the investors in the AIF (as well as of the AIF itself) and the integrity of the market. The manager has to introduce appropriate procedures to deal with conflicts of interest, to treat the investors in an AIF fairly and to use the required diligence in the performance of his or her duties.

Managers of Austrian private equity funds are most frequently general partners of an LP or fulfil their function based on management agreements with the fund vehicle. Thus, the scope of the managers’ duties and the extent of their liability in relation to the investors (and the fund vehicle) derive from the partnership agreement (supplemented by the mandatory provisions of the Commercial Code) or, as the case may be, the management agreement.

Unless the private equity fund is an AIF, it is possible to limit the liability of the sponsor in relation to the investors, or limit the liability of the fund vehicle by contractual provisions (e.g., to exclude liability for ‘ordinary negligence’). However, such contractual provisions would still be subject to judicial review.

**III REGULATORY DEVELOPMENTS**

Private equity funds established as AIFs and their managers are subject to the ongoing supervision of the FMA. The FMA has a wide range of inspection and audit rights with respect to both the AIFM and the individual AIFs.

Austrian law distinguishes between AIFMs, which require licensing by the FMA, and AIFMs, which only have to register with the FMA. Licensed AIFMs do not require any additional licences for their management activities for the fund. Registered AIFMs may require a business permit for asset managers.

Investors holding qualified participations in the AIFM (i.e., shareholdings exceeding 10 per cent) must be disclosed to the FMA, but only by licensed AIFMs.

Private equity funds established as AIFs must be registered with the FMA. Private equity funds established as AIFs and managed by a licensed AIFM also require approval by the FMA. Austrian AIFs are also listed in an informal register maintained by the FMA.

Private equity funds not established as AIFs require no special registration, except for the registration with the Companies Register upon incorporation.

If the sponsor also acts as the manager of a fund established as an AIF, it has to be registered or, as the case may be, licensed with the FMA. In addition, if the sponsor holds a qualified participation in the fund, this fact has to be disclosed to the FMA.

Otherwise, no specific licence requirements exist for the sponsors of a fund.
**Taxation**

**Taxation of the fund**

The most common private equity fund vehicle in Austria is a partnership. Different from corporations, Austrian partnerships are typically viewed as transparent for tax purposes, provided that the partnership's sole activity qualifies as asset management for tax purposes, and it is not deemed to operate a business or commercial operation.

Any income derived by the partnership is allocated to its investors and taxed at their level in accordance with the rules of the tax regime applicable to the individual investor.

Since 1 January 2016, Austria has not levied capital duty on equity contributions. However, stamp duty, in particular in relation to guarantees that the formation documentation may entail, is still an area to be considered. In this context, it should be noted that surety agreements (including any form of assumption of a debt as joint debtor) are subject to stamp duty at a rate of 1 per cent of the secured amount provided that the surety is of an accessory nature, which means that the guarantor may avail itself not only of all defences that it personally has against the creditor, but also of all defences that the debtors of the secured debt have against the creditors. However, if the guarantee is of an abstract nature, meaning that the guarantor has to pay upon first demand and has recourse only to those defences that arise from the guarantee itself, then the transaction is not subject to stamp duty. Therefore, guarantee wordings explicitly stating that a specific guarantee is intended as an abstract are commonly used.

**Taxation of investors**

Domestic individual investors are taxed as follows: capital gains are subject to a preferred tax rate of 27.5 per cent; and dividends are subject to withholding tax at a rate of 27.5 per cent.

Domestic corporate investors are taxed as follows: capital gains are taxed at a rate of 25 per cent if they relate to an Austrian-resident portfolio company, and may be tax-exempt if they relate to a foreign-resident portfolio company in which a minimum shareholding of 10 per cent is (indirectly) held for an uninterrupted period of at least one year (Section 10, KStG); and dividends are tax-exempt if they relate to an Austrian-resident portfolio company or an EU-resident portfolio company, and may be tax-exempt under certain conditions if they relate to another foreign portfolio company (Section 10, KStG). On 1 January 2019, new provisions in connection with international participations and foreign portfolio shareholdings came into force, along with new controlled foreign corporation taxation rules.

Foreign individual investors are taxed as follows: capital gains are only taxable (at a rate of 27.5 per cent) if the percentage of the investor's (weighted) shareholding in the Austrian portfolio company (through the partnership) exceeded 1 per cent at any time during the past five years. Note that double-tax treaties usually restrict Austria's right to tax such capital gains (Article 13, Paragraph 5 of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (MTC)); and dividends are subject to withholding tax at a rate of 27.5 per cent (as of 1 January 2016) (subject to a reduction under applicable double tax treaties).

Foreign corporate investors are taxed as follows: capital gains are only taxable (at a rate of 25 per cent) if the percentage of the investor's (weighted) shareholding in the Austrian portfolio company (through the partnership) exceeded 1 per cent at any time during the past five years. Double-tax treaties usually restrict Austria's right to tax such capital gains (Article 13, Paragraph 5, MTC); and dividends are subject to withholding tax at a rate of
25 per cent in cases where the exemption for foreign investors that are corporations resident in an EU Member State is not applicable (but will usually be subject to a reduction under applicable double tax treaties).

**Taxation of carried interest**

Carried interest, which is defined as the compensation of a partner of an asset management partnership received because of outstanding contributions to the successful management of the investments, is included in the investment income according to the Department of International Taxation of the Ministry of Finance. Income qualifying as investment income received by an individual who is subject to unlimited taxation in Austria is taxable in Austria with the special tax rate of 27.5 per cent. Despite this administrative guideline, a case-by-case analysis is recommended, as the line between self-employed and employee income and investment income is rather unclear.

The management fees received by a partner of an asset management partnership are not subject to VAT. According to the Austrian tax authorities, the managing partner of a partnership is not an entrepreneur; his or her services are supplied in the exercise of a corporate function, and not as a result of an exchange of services. If the fund vehicle is a corporation, however, the fees of a managing partner will usually be subject to VAT, unless the manager is employed by the corporation.

**IV OUTLOOK**

Fundraising by Austria-based private equity remains low compared to other European countries and no significant pickup of funding activities is expected in the short term.

Politically, it remains to be seen whether the new Austrian government will make good on its announcement of its intention to implement a programme to provide incentives for private equity investment into start-ups and SMEs.

---

Chapter 2

BRAZIL

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I GENERAL OVERVIEW

The Brazilian private equity fundraising sector has consolidated in the past decade and shown significant growth since 2003, even compared with other BRIC countries.

This evolution can be attributed to Brazil’s economic development over this period and to the continuous improvement of the regulatory structures of the capital markets, chiefly regarding the main type of investment vehicle for the private equity segment, equity investment funds (FIPs).

As a result of this evolution, the Brazilian Securities and Exchange Commission (CVM) has been constantly concerned with regulating and updating specific rules for these funds, including the issuance of CVM Instruction No. 578/16 on 30 August 2016, which, as is discussed below, replaced CVM Instruction No. 391/03 and modernised the rules regarding the formation, operation and management of private equity funds.

More recently, the enactment of Law No. 13,874 of 20 September 2019, also known as the Brazilian Economic Freedom Law, represented important progress in the regulatory framework applicable to FIPs, as explained in Section II.i. According to recent studies published by the Brazilian Private Equity and Venture Capital Association (ABVCAP), between 2011 and 2018, despite the economic and political turmoil experienced in Brazil, investments by local and international investors in the private equity industry showed an upward trend, especially in 2018 when the total committed capital reached US$38 billion.

2019 was marked by the beginning of the new right-wing administration and approval of important economic and legal measures, such as the Economic Freedom Law and the social security reform, which created a positive scenario for investment in Brazil. According to a report prepared by the Transactional Track Record, the total aggregate value of private equity transactions in 2019 represented an increase of more than 27 per cent compared with 2018, reaching a record volume of US$6.5 billion.

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3 Conversion from Brazilian reais into US dollars is according to the exchange rate announced by the Brazilian Central Bank on 31 December 2019.

Investments carried out in the oil and gas sector played an important role in the Brazilian private equity sector during 2019 and must be highlighted. In June, ENGIE, a French-based energy and solutions company, and the largest private power producer in Brazil, and Caisse de dépôt et placement du Québec, a Canada-based fund, acquired a 90 per cent holding in Transportadora Associada de Gás SA, a major natural gas transmission company previously owned by Petrobras, for the amount of, approximately, US$8.1 billion.

Another important transaction in the oil and gas sector was the investment of a private equity fund managed by Starboard Asset in the oil company 3R Petroleum, aimed at acquiring an onshore oil field from Petrobras in the amount of approximately US$191.1 million. Upon the fulfilment of certain conditions precedent, the acquisition will mark the first time a private equity fund takes over the operation of an onshore oil field.

Petrobras’ divestment process shall attract more investors in the next few years. The management board has already approved its five-year strategic plan to continue such process, which aims to sell various assets for up to US$30 billion, including eight oil refineries. According to Petrobras, the main company goals of the plan are debt reduction and the focus on the pre-salt area.5

Other standout investments were those performed in the technology segment by the Japanese Softbank Group Corp. At the beginning of 2019, the group launched the SoftBank Innovation Fund, a technology fund focused exclusively in the Latin American market, which invested in at least 14 Latin American technology start-ups during the course of 2019.6 It has also announced the SoftBank Latin America Local Hub, a local group specifically created to manage SoftBank’s portfolio companies in Latin America.7

This growing tendency of investment in the private equity industry is directly related to the development of Brazilian start-up companies that have been attracting local and foreign investors, especially in the technology segment. During 2019, certain Brazilian companies, including Loggi, Gympass, QuintoAndar, Ebanx and Wildlife Studios, were added to the list of global ‘unicorns’ (start-ups valued at over US$1 billion).8 At the very beginning of 2020, another Brazilian start-up company, Loft, which focuses on the acquisition of real estate for refurbishment and subsequent sale, was also consolidated as a unicorn, after a new round of investment led by US funds Vulcan Capital and Andreessen Horowitz, in the amount of, approximately, US$175 million.9

Following this start-up movement, another type of investment that is progressively gaining strength in Brazil is corporate venture capital (CVC), which is the investment by well-established institutions in early stage companies (that are outside the investing company’s corporate chain). The main purpose of CVC investment is for the well-established company to develop a new product or specific market upon investment in an early stage company,

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6 Among the Brazilian start-ups that received investments from Softbank fund are Rappi (delivery platform), Loggi (delivery platform), Credistas (credit fintech), QuintoAndar (real estate platform), Gympass (wellness platform), Buser (bus platform), Olist (e-commerce platform), Vtex (e-commerce platform), MadeiraMadeira (home goods platform), Volanty (car platform) and Banco Inter (digital bank).
rather than by setting up an internal research and development (R&D) department, as the R&D route may prove to be more costly, time-consuming and demanding than the alternative of investing in an early stage company.

Many Brazilian companies have embraced CVC investment for innovation purposes, including Embraer SA (the Brazilian business conglomerate that manufactures commercial and military aircraft, among other things), banks Banco de Brasil, Banco BMG, Itaú and Santander, manufacturers Gerdau, Votorantim and Natura (a cosmetics manufacturer), and retailers Pão de Açúcar and Magazine Luiza. Market experts forecast that the current economic landscape, the substantial devaluation of the Brazilian real against the US dollar, the UK pound and the euro, and the low interest rates – including the basic rate (Selic) that has been steadily lowered by the Brazilian Central Bank (BACEN) – will be incredibly positive for the private equity sector in 2020, especially with regard to foreign players.10

This scenario shall mean greater demand from foreign funds and banks for local portfolio managers, which have better knowledge of the internal market and, hence, greater capacity to identify the best investment opportunities. In this regard, according to the ranking by the Brazilian Association of Financial and Capital Market Entities (ANBIMA), the Brazilian portfolio managers responsible for most of the assets up to November 2019 were BB DTVM SA, Itaú Unibanco SA and Bradesco.11

II LEGAL FRAMEWORK FOR FUNDRAISING

To understand the fundraising industry in Brazil, it is first necessary to analyse the offshore structures adopted by local and foreign players before entering into a specific analysis.

i Vehicles for fundraising

The main offshore vehicles and jurisdictions used for fundraising are legal entities incorporated as holding companies in Luxembourg and Amsterdam, foreign securities holding entities in Spain and limited liability companies (LLCs) in Delaware, United States.

The above-mentioned countries stand out for investments in Brazil, and in most cases the investments are made directly into Brazilian companies or FIPs.

Even though FIPs are the main vehicle for investment in the industry, certain players do not use them, which at times makes it difficult to estimate the exact volume of funds raised for private equity investments in Brazil.

Many offshore fundraising entities end up entering Brazil by means of a holding company – an LLC or corporation – that acts as a vehicle for unifying and carrying out these investments. The main jurisdictions used for fundraising are those included on the Brazilian ‘grey list’ – countries that grant privileged tax regimes.12

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12 Pursuant to the terms of Law No. 11,727/08, a country is considered to grant a privileged tax regime if it: does not tax income or taxes it at a maximum rate of less than 20 per cent; grants tax benefits to non-resident individuals or legal entities without requiring that a substantial economic activity be carried out in the country and conditional on the non-exercise of a substantial economic activity in the country; does not tax – or taxes at a maximum rate of less than 20 per cent – income earned outside its territory;
In any event, FIPs are also a solid alternative for investors, to the extent they allow investments in public or private companies, as well as being a flexible vehicle when compared to other types of investment funds in Brazil.

The FIP is a communion of funds for the purchase of shares, subscription warrants, non-convertible debentures or other securities convertible into or exchangeable for shares of public or private companies, as well as titles and securities representing equity participation in LLCs, and it is required to maintain at least 90 per cent of its resources invested in assets of this nature. FIPs do not have separate legal personality; they are organised as closed-ended condominiums held by a pool of owners (individuals or legal entities), each being entitled to a portion (shares) of the total assets.

Due to the lack of specific federal legislation regarding investment funds, up until 2019 FIPs were subject to general provisions applicable to condominiums in the Brazilian Civil Code, as well as to specific rules issued by the CVM.

In 2019, a new regulatory framework was created upon the enactment of the Brazilian Economic Freedom Law. By adding an entire chapter regarding investment funds in the Brazilian Civil Code, such law introduced the legal grounds for the regulation of investment funds by the CVM.

Pursuant to the new provisions and subject to CVM regulation, the funds’ by-laws shall be allowed to establish limitation to the liability of the FIP’s shareholders to the value of their shares and also to the obligations attributable to the class of shares held by the shareholders, as well as limitation to the liability of the funds’ service providers (e.g., administrators and portfolio managers) to the obligations to be complied with by each of them (without being jointly liable), provided that the rules enacted by the CVM are also complied with. The Economic Freedom Law also allows the creation of segregated assets for each class of shares of the FIP. Such new rules play an important role in the development of the Brazilian private equity industry by bringing internal practices closer to international practices, and represent a safer, cost-effective and more attractive environment for investors and service providers.

An important development introduced by CVM Instruction No. 578/16 was the permission for FIPs to invest, in addition to the convertible debentures that were already authorised by the rules in effect, in non-convertible debentures, up to the limit of 33 per cent of the total subscribed capital of the fund, except for infrastructure FIPs and intensive economic production in research development and innovation FIPs, which can invest in any amount of debentures that are convertible or non-convertible into shares.

FIPs do not allow for the redemption of shares, except in the event of liquidation of the fund.

According to the current wording of CVM Instruction No. 578/16, if the FIP’s administrator hires third parties to render treasury services, activities of controlling and processing of portfolio assets or bookkeeping for the issuance or redemption of shares, the services agreement shall contain a provision establishing that the FIP’s administrator and the relevant third party are jointly liable for any damage ultimately caused to the FIP’s shareholders resulting from the violation of any law, the FIP’s by-laws or CVM rulings. In view of the contradiction with the recently enacted Brazilian Economic Freedom Law, the CVM has stated that a public hearing will be submitted to issue new Instructions that will reflect, on the current regulation, the innovations brought by the Economic Freedom Law, thus, reviewing the joint liability of the administrator and relevant third parties. Available at www.cvm.gov.br/noticias/arquivos/2019/20190923-3.html. Accessed on 9 January 2020.
The formation, operation and management of FIPs; and the accounting methods for the classification of assets and liabilities and the financial aspects related to FIPs are regulated, respectively, by CVM Instructions Nos. 578/16 and 579/16, both enacted on 30 August 2016, which modernised the former rules set forth by the revoked CVM Instruction No. 391/03.

As regards fund management, the current legislation requires that fund administrators be Brazilian legal entities authorised by the CVM to carry out the professional services of securities portfolio administration.

The administration of a FIP comprises all the services directly or indirectly related to its representation, operation and maintenance, such as portfolio management; investment advising; treasury and assets processing control activities; placement of shares; and bookkeeping of the issuance and redemption of shares.

According to CVM Instruction No. 578/16, the FIP’s administrator may also, on behalf of the fund, engage third parties to render the following services:

\begin{itemize}
  \item [a] the FIP’s portfolio management;
  \item [b] investment advising;
  \item [c] treasury activities;
  \item [d] assets processing control activities;
  \item [e] placement of shares;
  \item [f] bookkeeping of issuance and redemption of shares;
  \item [g] custody of financial assets; and
  \item [h] market maker for the FIP’s shares.
\end{itemize}

CVM Instruction No. 578/16 currently establishes that the FIP’s administrators and any other service providers hired are liable before the CVM and in accordance with the relevant charge, for the violation of any law, applicable rulings or the fund’s by-laws.

This CVM Instruction has also increased the duties and obligations of the portfolio management related to the hiring of services of investment or divestiture, as well as the role of the portfolio management on the pricing of the FIP’s investments. In this regard, according to CVM Instruction No. 578/16, the portfolio manager has powers to represent the FIP in certain acts, such as negotiation with and hiring of the assets and agents to conduct the FIP’s transactions, on behalf of the fund; negotiation with and hiring of third parties for the rendering of services of advising and consulting directly related to the investment and divestiture of the fund, as established in the FIP’s investment policy; and monitoring the assets of the FIP and exercising the voting right related to the assets, subject to the voting policy established by the portfolio manager. In the absence of a specific provision in the FIP’s by-laws or in the agreements entered into by the FIP’s administrator and portfolio manager, the latter shall send to the administrator, within five business days, the copies of all documents executed on behalf of the FIP.

CVM Instruction No. 558/15, as amended by CVM Instructions Nos. 593/17\textsuperscript{16} and 597/18,\textsuperscript{17} has introduced new rules on the activities related to securities portfolio

\textsuperscript{16} CVM Instruction No. 593/17 was enacted on 17 November 2017.

\textsuperscript{17} CVM Instruction No. 593/18 was enacted on 26 April 2018.
administration in general. These rules include, among other things, two categories of registration of portfolio administration, as well as new requirements and procedures related to the registration of these categories:

- **portfolio manager**: individuals or legal entities that are authorised to manage the funds’ assets, including the application of financial resources in the securities market, on behalf of the investor; and
- **fiduciary administrator**: legal entities that are authorised to carry out all activities directly or indirectly related to the functioning and maintenance of the securities portfolio, including the custody, controlling of assets and debts, and, in general, the supervision of the management. The CVM Instruction mentioned above also establishes the possibility of a legal entity that is not a financial institution to require the registration as fiduciary administrator, as long as it complies with some requirements established by the CVM.

With the establishment of the two categories of registration mentioned above, the CVM has expressly established a separation of the activities of custody and controlling of assets and debts from those of portfolio management. An important amendment introduced by CVM Instruction No. 593/17 is that portfolio managers are no longer authorised to render securities consulting services unless they obtain CVM accreditation as a securities consultant and comply with the provisions of CVM Instruction No. 592/17.19

In addition, pursuant to CVM Instruction No. 558/15, as amended by CVM Instruction Nos. 593/17 and 597/18, to be granted registration for securities portfolio administration, a legal entity established in Brazil is, among other things, required to appoint:

- **one or more officers** (authorised by the CVM) responsible for the management activities;
- **a compliance officer** responsible for the implementation of the rules set out by CVM Instruction No. 558/15, as well as the procedures, policies and internal controls of the funds; and
- specifically for the category of portfolio manager, an officer responsible for the risk management (it is possible for the compliance officer to take on this duty as well).

The securities portfolio administration registered in both categories mentioned in items (a) and (b), above (portfolio manager and fiduciary administrator), shall also appoint an officer exclusively responsible for the activity of fiduciary administration. In addition, the above-mentioned CVM Instruction also establishes that the officers responsible for the management activities, the compliance officer, the officer responsible for the risk management and the officer responsible for the distribution of shares may also execute these roles in controlling companies, controlled companies, companies under common control or certain subsidiaries. The amendments introduced by CVM Instruction No. 597/18 have also established that the officers and the portfolio administrator (where the administrator is an individual) are not allowed to obtain or maintain enrolment as an autonomous investment agent.

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18 According to CVM Instruction No. 558/15, the portfolio administrator can request registration in only one or in both categories and is also able to request the CVM to change its category.

19 CVM Instruction No. 592/17 was enacted on 17 November 2017.
Finally, it is also important to mention that upon the enactment of CVM Instruction No. 558/15, where the securities portfolio administrator is a legal entity, it is authorised to carry out the placement of shares issued by the investment funds managed by that entity, even if the latter is not a financial institution, subject to compliance with certain requirements established by the CVM.

ii Disclosure of information

The FIP’s administrator must disclose to all its investors, in the form established in the FIP’s by-laws, and through the CVM’s system of provision of documents, as well as to the organised market management entities where the FIP’s shares are placed, any material act or fact related to the fund or to the assets that comprise the FIP’s portfolio, except if the fund’s administrator understands that the disclosure of the information threatens the interests of the fund or of its invested companies.

In line with such duty, the CVM imposes on the administrators, by means of Article 46 of CVM Instruction No. 578/16, the obligation to periodically present to the CVM information on the accounting and financial status of the client FIPs through an electronic system on its website. The required information is as follows:

a within 15 days of the end of each quarter, the information established in Schedule 46-I of CVM Instruction No. 578/16 (i.e., the name of the FIP and its administrator, net equity of the fund, amount of subscribed capital and paid up shares, number of shareholders in each category, equity held by each category, etc.);

b on a semi-annual basis, and within 150 days of the end of this period, the portfolio composition, specifying the number and types of securities held;

c annually, within 150 days of the end of the fiscal (calendar) year, the financial statements for the year with the independent auditor’s opinion and the administrator’s and portfolio manager’s opinion.

iii Conduct and governance obligations

As well as the above-mentioned disclosure obligations, Article 16 of CVM Instruction No. 558/15 (which revoked CVM Instruction No. 306/99), as amended by CVM Instruction Nos. 593/17 and 597/18, provides that the administrator and portfolio manager are subject to the following strict conduct rules in the performance of their duties:

a to fulfil duties with good faith, transparency, diligence and loyalty to the interests of clients;

b to fulfil duties in such a way as to meet the investment goals of the holder or holders of the portfolio and avoiding practices that could breach their trust;

c to fulfil the provisions of the fund’s by-laws or the agreement executed with the client, which must contain the basic characteristics of the services to be rendered, including:

* the investment policy to be adopted;

* the detailed description of the compensation payable in exchange for the services;

20 This information shall be sent to the CVM based on the fiscal year of the FIP.

21 CVM Instruction No. 578/16 has waived the necessity of provision of the non-audited financial statements on a semi-annual basis, as previously provided by CVM Instruction No. 391/03 (revoked by CVM Instruction No. 578/16), and has increased the term for the provision of the audited financial statements from 120 to 150 days.
• the risks inherent to the different types of transactions with securities in stock exchanges, over-the-counter markets, futures markets and share loan transactions that the manager intends to carry out using investors’ funds;
• the contents and periodicity of the information to be rendered by the manager to the client; and
• information about other activities that the manager itself may carry out in the market and any potential conflicts of interest existing between those activities and the management of the portfolio;

d to keep all documents relating to the transactions with securities that are part of the portfolios under management updated, in perfect order and available to the client, in the form and for the term set out in the internal rules and regulations;

e to hire custody services or to certify that the securities that are part of the portfolios under management are kept under the custody of a duly accredited entity and to take all actions as may be useful or necessary to protect the interests of its clients;

f to transfer to the portfolio any benefit or advantage that may result from its standing as the manager of the portfolio, subject to the exception expressly set out in specific regulation of investment funds;

g as regards the portfolio under management, to contractually establish the information that will be rendered to the client, related to the investment policy and to the securities of the portfolio under management;

h to inform the CVM, whenever it verifies, in the performance of its duties, the occurrence or evidence of violation of any rule that the CVM monitors, within a maximum term of 10 business days counted from the occurrence or identification of the occurrence; and

i where an administrator is a legal entity, to establish the policy related to the negotiation of securities by officers, employees, collaborators, controlling partners and by the company itself.

CVM Instruction No. 593/17 has also included a new provision to CVM Instruction No. 558/15 establishing that the rendering of services of securities portfolio administration, by means of using automated systems or algorithms, is subject to the obligations and rules established in CVM Instruction No. 558/15, as amended by CVM Instruction No. 593/17, and does not mitigate the portfolio administrator’s liabilities. In addition, the source code of the automated system or algorithm shall be available for CVM inspection in the company’s headquarters, in a non-compiled version.

Pursuant to CVM Instruction No. 578/16, FIPs are required to take part in the decision-making process of the investee companies, exerting influence on the definition of their strategic policies and management. This participation may also be carried out by holding shares that are a part of the corresponding controlling block; entering into shareholder agreements; or entering into similar agreements or adopting procedures that guarantee the fund’s influence in the definition of the strategic policies and management of the investee companies, including by means of appointment of members of the board of directors. The requirement of participation of the FIP in the decision-making process of the investee companies does not apply if: (1) the investment by the FIP in the investee company

22 The portfolio administrator registered exclusively in the category of portfolio manager, and exercising its duties in investments funds, does not have to comply with items (d) and (e).
is reduced to less than half of the percentage originally invested and, as a result, represents an amount lower than 15 per cent of the capital of the investee company; or (2) the book value of the investment is reduced to zero and is approved by a shareholders’ resolution by the majority of shareholders present at the meeting, if a higher quorum is not established in the FIP’s by-laws.

The requirement to exert influence on the strategic policies and management of the investee companies does not apply to investment in companies listed in special trading segments created by stock exchanges or over-the-counter markets aimed at the access market, and that ensures, contractually, corporate governance standards stricter than those required by law, provided that the investment corresponds to up to 35 per cent\textsuperscript{23} of the FIP’s subscribed capital.

Furthermore, except for companies that meet the above-mentioned conditions, closely held companies that receive FIP investments must adopt the following governance practices, guaranteeing greater protection to investors:

\(a\) a prohibition on issuing founders’ shares, with measures taken to ensure the absence of securities of this type in the market;

\(b\) establishment of a unified term of office of up to two years for all the members of the board of directors, if such a board exists in the company;

\(c\) to make available to the shareholders, agreements with related parties, shareholders’ agreements and option plans for the acquisition of shares or other securities issued by the investee company;

\(d\) to resolve corporate disputes through arbitration;

\(e\) in the event that the investee company goes public through category A,\textsuperscript{24} it must undertake to the fund to join a special listing segment of a stock exchange or of an organised over-the-counter market management entity that guarantees at least the differentiated levels of corporate governance practices provided in the items above; and

\(f\) an annual audit of their financial statements by an independent auditor registered with the CVM.

\textbf{iv} FIP portfolios

According to the new CVM Instruction No. 578/16, FIPs are classified into the following categories, as regards the portfolio composition:

\(a\) seed capital;

\begin{itemize}
\item \textsuperscript{23} This limit will be of 100 per cent during the term of allocation of the resources, established in up to six months counted from each event of payment of shares set out in the instrument of investment commitment. If, at the end of the relevant month, the fund supersedes the limit of 35 per cent mentioned above, for reasons beyond the control of the portfolio manager, and this non-compliance continues until the end of the following month, the FIP’s administrator shall immediately inform the CVM of the non-compliance and the related reasons, as well as the expected term for compliance, and inform the CVM about the effective compliance, when it occurs.
\item \textsuperscript{24} Pursuant to CVM Instruction No. 480/09, the registration of corporations with the CVM may be made within the following categories: Category A, which authorises the trading of any securities by the corporation in regulated securities market; or Category B, which authorises the trading of securities by the corporation in regulated securities market, except for (1) shares or certificates of share deposits; or (2) securities that grant to their holder the right to acquire the securities mentioned in item (1) as a consequence of their conversion or of the exercise of rights attributed to them, provided that they are issued by the issuer of the securities mentioned in item (1) or by a corporation of the same group of that issuer.
\end{itemize}
Each category of FIP as described above is allowed its own investment policy, subject to the applicable rules established by the CVM. Seed capital, emerging company and multi-strategy FIPs, for instance, are allowed to invest in limited liability companies, which was a significant change introduced by CVM Instruction No. 578/16, compared with CVM Instruction No. 391/03, and represents an important step for the development of new investments in Brazil, facilitating the funding of early stage companies. The corporations or limited liability companies that comprise the portfolio of seed capital FIPs shall have an annual gross revenue of up to 16 million reais as accrued in the fiscal year ending prior to the first payment of the fund, and shall not have presented a revenue greater than this limit in the past three fiscal years. Such corporations and limited liability companies are exempt from compliance with the corporate governance requirements set out in CVM Instruction No. 578/16 (and expressly mentioned in Section II.iii), including exemption from the obligation to provide independent auditing of those companies. In the case of an increase of the annual gross revenues of the invested companies after the investment by the seed capital FIP, in such a way that it supersedes the above-mentioned limit, CVM Instruction No. 578/16 establishes certain transition rules related to the compliance by this category of FIP with corporate governance requirements.

In addition, among other rules, corporations or limited liability companies that comprise the portfolio of seed capital FIPs shall not be controlled, directly or indirectly, by a company or group of companies that has total assets in an amount greater than 80 million reais or annual gross revenue higher than 100 million reais in the end of the fiscal year ending prior to the first payment of the fund.

Another important development introduced by CVM Instruction No. 578/16 was the establishment of the possibility for all FIPs to invest up to 20 per cent of the subscribed capital abroad, as long as the foreign assets have the same economic nature of the assets that may be part of a FIP’s portfolio in Brazil, as described in Article 5 of CVM Instruction No. 578/16.25

Multi-strategy FIPs are allowed to combine investments across several categories and are intended exclusively for professional investors. Multi-strategy FIPs may invest up to 100 per cent of their subscribed capital abroad provided that: (1) their by-laws expressly include the possibility of investment in assets abroad as well as the maximum percentage of such investment; (2) their by-laws expressly set out the exclusive participation of professional investors; and (3) the term ‘investment in foreign assets’ is expressly mentioned in the FIP’s name.

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25 According to Article 5 of CVM Instruction No. 578/16, FIPs shall direct their funds to the purchase of shares, subscription warrants, non-convertible debentures or other securities convertible into or exchangeable for shares of public or private companies, as well as titles and securities representing equity participation in limited liability companies.
As regards emerging company FIPs, they may invest in corporations and limited liability companies with an annual gross revenue of up to 300 million Brazilian reais as accrued in the fiscal year ending prior to the first capital contribution of the fund, and shall not have presented a revenue greater than this limit in the past three fiscal years, and the invested companies are exempt from compliance with some of corporate governance requirements set out in CVM Instruction No. 578/16 (discussed in Section II.iii). However, if gross revenue is increased in such a way that it supersedes the above-mentioned limit after the FIP's investment, the emerging company shall comply with the corporate governance rules established in CVM Instruction No. 578/16 (discussed in Section II.iii), within two years of the end of the fiscal year in which the gross revenue supersedes the above-mentioned limit (300 million reais). It is also important to mention that the emerging companies invested in by emerging company FIPs may not be directly or indirectly controlled by a company or group of companies with total assets greater than 240 million reais or gross revenues greater than 300 million reais as accrued in the fiscal year ending prior to the first payment of the fund.

FIP-IEs and FIP-PD&IIs are not permitted to invest in limited liability companies and are restricted to investments in shares, subscription warrants, debentures (convertible or non-convertible into shares) or other securities issued by public or private corporations with investments in new projects of infrastructure or intensive economic production in research, development and innovation in Brazil in the energy, transport, water and basic sanitation, and irrigation sectors, among other areas deemed as priorities by the federal government. These categories of FIPs shall have at least five shareholders, provided that none of them hold more than 40 per cent of the shares issued by the FIP or earn an amount greater than 40 per cent of the FIP’s revenue.

Notably, among the developments introduced by CVM Instruction No. 578/16, FIPs are now allowed to advance funds for future capital increases of an invested corporation, whether a private or public corporation, as long as:

a the FIP holds shares in the invested corporation as at the date of the anticipation of funds;

b this option is expressly set out in the FIP’s by-laws, including the limit of the subscribed capital that may be subject to the anticipation of funds;

c the anticipation of funds is irrevocable and the anticipated funds shall be converted into capital; and

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26 CVM Instruction No. 578/16, which has created Emerging Company FIPs, has revoked CVM Instruction No. 209/94, which previously established the provisions for the establishment and development of the Mutual Fund for Investment in Emerging Companies (FMIEE). This fund was created in 1994 with the main purpose of investing in private corporations that had annual gross revenue up to 150 million Brazilian reais, as accrued in the fiscal year ended prior to the first payment of the fund. Another difference between FMIEEs and FIPs for emerging companies, is that FMIEEs did not have to comply with the same corporate governance requirements as currently established for the emerging company FIPs. According to CVM Instruction No. 578/16, the FMIEEs should have a term of either 12 months counted from the publication of the Instruction, or immediately if the existing FMIEEs conduct a public offering of shares (registered or not) after the publication of CVM Instruction No. 578/16, to be adapted to the rules of emerging company FIPs.

27 Pursuant to Section 1 of Article 17 of CVM Instruction No. 578/16, the new projects are considered those implemented after 22 January 2007.
the advanced funds are converted into capital increase of the invested company within 12 months.

**Offerings**

Pursuant to Article 4 of CVM Instruction No. 578/16, FIPs can only be the target of investment by qualified investors, and public offerings are the most suitable mechanism to raise such investments.

Pursuant to Article 19, Paragraph 3 of Law No. 6,385/76 (the Brazilian Securities Market Law), a public offering is one that is carried out by means of the use of sale or subscription lists or bulletins, flyers, prospectuses or advertisements aimed at the public; where the search for subscribers or purchasers is carried out by means of employees, agents or brokers; and where the negotiation is conducted in a store, office or venue open to the general public, or by means of public communication services.

In addition to the terms of the Brazilian Securities Market Law and CVM Instruction No. 400/03, as amended by CVM Instruction No. 584/17 and CVM Instruction No. 588/17, which sets out the objective requirements for an offering to be considered public, it is also necessary to observe subjective requirements that relate to the characteristics of the investors to which the offer is being made.

Information on the recipients of the offer and the availability of information on the fund and the securities issued are characteristics that must be observed for an offering to be defined as being public. Regarding information on the recipients, their degree of sophistication as investors must be analysed to verify that they possess enough knowledge and experience in financial and business issues and are able to assess the risks and merit of the investment. In relation to the availability of information on the fund and the shares issued, it must be shown that the target party had access to the information that the fund would have presented when registering the offering, so as to allow full evaluation of the risks.

The application for registration of the public offering shall be made to the CVM by the FIP together with the intermediary financial institution. The application shall be accompanied 28 Pursuant to CVM Instruction No. 554, enacted by the CVM on 17 December 2014, which came into force on 1 October 2015, qualified investors are: professional investors; individuals or legal entities that hold financial investments in an amount greater than 1 million reais and that furthermore attest in writing their qualified-investor status according to a specific instrument; individuals that have been approved in technical qualification tests or hold certifications approved by the CVM as requirements for their registration as independent investment agents, portfolio administrators, analysts and securities consultants, in relation to their own resources; and investment clubs, provided that they have the portfolio managed by one or more shareholders who are qualified investors.

In addition to the new concept of qualified investors, CVM Instruction No. 554/14 has also created a definition of professional investors, considered as those investors that are: financial institutions and other institutions authorised to function by the Central Bank of Brazil; insurance companies and capitalisation companies; closed or open pension plans entities; individuals or legal entities that hold financial investments in an amount greater than 10 million reais and that furthermore attest in writing their professional-investor status according to a specific instrument; investment funds; investment clubs, provided that they have their portfolio managed by portfolio administrators authorised by the CVM; independent investment agents, portfolio administrators, analysts and securities consultants authorised by the CVM, in relation to their own resources; and non-resident investors.

29 Article 19 of Law No. 6,385/76 sets out that ‘no public securities offering shall be distributed in the market without prior registry with the CVM’.
by the documents and information required under CVM Instruction No. 400/03, so as to allow full disclosure of the information on the offering, such as characteristics, volume and price of the offered shares, and the method and place of issuance.

Among these documents is the prospectus, set out under Article 38 of CVM Instruction No. 400/03, which is the main informative document to be presented by the fund. The prospectus must contain full information on the offering; the shares subject to the offering and the rights inherent therein; the offering party; the issuing fund and its economic and financial situation; third-party guarantors of obligations related to the shares being offered; and the types of companies that may receive the funds raised by the offering.

In this context, it is important to highlight that upon the enactment of CVM Instruction No. 578/16, the CVM has clarified an understanding that had already been adopted by Brazilian FIPs: the issuance of shares destined to the shareholders of the FIP is not considered a public offering, as long as the shares issued by the FIP are not admitted for trading in organised markets and the shares not placed for the shareholders are automatically cancelled.

The CVM also provides, by means of Instruction 476/09, for a different kind of public offering called a ‘public offering distributed with restricted efforts’. This type of offering is not subject to the registration rules set out by CVM Instruction No. 400/03. The offerings under the terms of this instruction may have as targets, among other securities, closed investment fund shares (such as FIPs) and may only be directed to professional investors, as defined in specific regulation.

Furthermore, for a public offering to be considered an offering with restricted efforts, it is also necessary that the number of investors pursued is limited to 75 professional investors, and that the securities are subscribed or acquired by no more than 50 of those targeted investors.\(^\text{30}\) This is the Brazilian version of the American private placement, when an offer is made directly to qualified investors with no purchase efforts being made to the public in general.

With the enactment of CVM Instruction No. 551/14, the CVM has increased the list of securities that may be distributed with restricted efforts, which now includes, inter alia, the following securities: certificates of structured transactions, shares, debentures convertible into or exchangeable for shares and subscription warrants issued by certain companies. This measure aims to meet a proposal by some capital market entities to facilitate small and medium-sized companies’ access to capital markets funding.

Another important characteristic of FIPs is that they are allowed, upon approval by a qualified majority of the investors, to post sureties, guarantees, acceptances, co-obligations or in rem guarantees (collaterals). The provision to this effect was initially included in CVM Instruction No. 391/03 (by means of the enactment of CVM Instruction No. 535/13) and

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\(^{30}\) Upon the enactment of CVM Instruction No. 551, as of 25 September 2014, the limitation of the number of qualified investors that can be pursued was increased from 50 to 75 qualified investors, and the maximum number of securities that can be acquired by qualified investors was increased from 20 to 50.

Upon the enactment of CVM Instruction No. 554/14, the reference to ‘qualified investors’ in Articles 3, 1 and II of CVM Instruction No. 476/09 was replaced by ‘professional investors’.
kept in the wording of CVM Instruction No. 578/16 (which revoked CVM Instruction No. 391/03), and had as one of its goals to increase the participation of FIPs in leveraged buyouts.

Finally, it is also worth mentioning the development of equity crowdfunding regulation in Brazil, upon the enactment of CVM Instruction No. 588/17. The main goal of equity crowdfunding, by means of online platforms, is to give access to the investors to invest in start-up companies, which still suffer from a shortage of resources, particularly in light of the recent economic crisis in Brazil. Investment through equity crowdfunding is an important financing instrument for early stage companies and is crucial for enhancing employment and generating income in the Brazilian economy.

The main purpose of CVM Instruction No. 588/17 is to allow companies with annual revenues of up to 10 million Brazilian reais to carry out offerings by means of online platforms of collective financing, without registration of the public offerings. For purposes of protecting the investors, the CVM has established as a condition to this type of offering that it occurs by means of online platforms that are submitted to the authorisation process before the CVM.

It is also important to mention that even before the enactment of CVM Instruction No. 588/17, the issuance of securities by means of equity crowdfunding in Brazil was already permitted and had been carried out by some start-ups upon the application of CVM Instruction No. 400/03, which allows the public offering of securities issued by small companies in Brazil (MEs and EPPs) to be carried out without registration. Despite the recent enactment of the crowdfunding regulation, crowdfunding is not yet common practice in Brazil, mainly because of the economic and political crisis experienced in Brazil over recent years, which makes investors sceptical about taking risks of this nature.

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31 CVM Instruction No. 578/16 kept the wording of CVM Instruction No. 391/03 related to the possibility of granting guarantees by the FIPs, upon the approval of the shareholders’ meeting, and included in rem guarantees (collaterals) in the list of guarantees.

32 According to Brazilian Complementary Law (LC) No. 123/06, as amended by Brazilian LC No. 155/16, a microbusiness (ME) is a company (under the types established in this LC), or a businessperson, that has in each fiscal year a gross revenue equal to or lower than 360,000 Brazilian reais, and a small business (EPP) is a company (under the types established in this LC), or a businessperson, that has a gross revenue greater than 360,000 Brazilian reais and equal to or lower than 4.8 million Brazilian reais in each fiscal year. In addition, Brazilian Law No. 155/16 has created the option for ‘angel investors’, whether individuals or legal entities, to invest in MEs and EPPs for purposes of enhancing innovation and productive investments without having to hold equity in the companies or being liable for any of the company’s debts or insolvencies. In addition, angel investors shall not have any voting right nor influence on the company’s management. The funds granted by the angel investors to the companies shall not be considered as part of the companies’ capital and the angel investors shall be compensated for the investments made, according to the terms of the investment agreement, during a term of up to five years, provided that the compensation shall not be greater than 50 per cent of the profits of the MEs or EPPs.
III  REGULATORY DEVELOPMENTS

The Brazilian Securities Market Law determines that the CVM shall, among other obligations, supervise the issuance and distribution of securities in the market, portfolio management and safekeeping of securities, as well as the services provided by securities consultants and analysts. Since investment fund shares are considered securities for all purposes, they are subject to the provisions of this Law.

In this way, without prejudice to the above-mentioned registration procedures for public offerings, and pursuant to Article 2 of CVM Instruction No. 578/16, the mere existence of a FIP depends on previous registration with the CVM, which shall be automatically granted upon delivery of the following documents and information:

a. incorporation documents and the full text of the by-laws;\(^33\)
b. the administrator’s statement that it has executed the applicable agreements whenever the FIP’s administrator hires, on behalf of the FIP, third parties to render the services set out in Article 33, Paragraph 2 of CVM Instruction No. 578/16,\(^34\) and that the agreements are available to the CVM;
c. a statement specifying the name of the independent auditor;
d. information on the maximum and minimum numbers of shares to be placed, their issue price, all costs incurred in the placement and other relevant information concerning the placement;
e. marketing material used in the placement of the fund’s shares, including the prospectus, if any;
f. any additional information that may be provided to potential investors; and
g. the number of the FIP’s enrolment with the National Registry of Legal Entities (CNPJ).

As well as the rules issued by the CVM, entities associated with the ABVCAP and ANBIMA must also observe the terms of the Code for Regulation and Best Practices (the Code), which was drafted by both associations and determines certain general parameters related to the establishment and operation of FIPs and other investment vehicles. The activities of administration, portfolio management and distribution of FIP shares are subject to the provisions of the Code. The Code mainly aims to:

a. allow for greater transparency in the performance of the activities of FIPs (and other investment vehicles governed by the Code), allowing better quantification and supervision of the sector’s development;
b. promote the standardisation of practices and procedures of FIPs (and other investment vehicles);
c. promote the adequate functioning and credibility of FIPs (and that of other investment vehicles);

\(^33\) Recently enacted CVM Instruction No. 615/19, of 2 October 2019, has waived the necessity of registration of the by-laws before a registry of instruments and documents, as previously established in CVM Instruction No. 578/16, which, in other words, means that the registration of the by-laws before the CVM is now sufficient to ensure its effects before third parties.

\(^34\) According to Article 33, Paragraph 2 of CVM Instruction No. 578/16, the FIP’s administrator may hire, on behalf of the fund, the following services: (1) FIP’s portfolio management; (2) investment advising; (3) treasury activities; (4) assets processing control activities; (5) placement of shares; (6) bookkeeping of issuance and redemption of shares; (7) custody of financial assets; and (8) market maker for the FIP’s shares.
d maintain the highest ethical standards and consolidate the institutionalisation of fair practices;
e raise the fiduciary standards and promote best practices; and
f allow for, as the case may be, the compatibility and gradual integration of the Brazilian FIP market with the international private equity and venture capital market.

As regards fundraising carried out in other jurisdictions, the terms of Law No. 4,131/62 must be observed regarding the definition of foreign capital, and the inflow of funds directly into Brazil, and the terms of National Monetary Council (CMN) Resolution No. 4,373/14 must also be observed whenever such funds enter Brazil through the capital markets.35

In cases of direct investment, every foreign investor and every Brazilian company in which the foreign investor participates must be registered with the Brazilian Central Bank. Additionally, every inflow or outflow of money arising out of such investment must also be registered, including for transactions involving acquisition or sale of equity interests.

Recent amendments introduced by the Brazilian Federal Revenue (RFB) by means of Rule No. 1,634 (IN 1,634/2016), further replaced by Rule No. 1,863 (IN 1,863/2018), as amended,36 governing the registration of national and foreign entities with the CNPJ have established the obligation for foreign shareholders of Brazilian entities, and also for Brazilian entities, to provide the RFB with information on the relevant corporate chain, including trusts and foundations, up to the individuals deemed the ultimate beneficial owners, with a few exceptions, defined as (1) the individual or individuals who either directly or indirectly own, control or significantly influence37 the legal entity; or (2) the individual under whose name a given transaction is performed. This obligation must be complied with during any update of any of the Brazilian or foreign entity's RFB registry data or, in the case of a new entity, up to 90 days from the date of registration before the RFB.38

This Rule also permits some exceptions to compliance with the above-mentioned obligation, such as in the case of (1) a publicly held corporation incorporated in Brazil or in another jurisdiction that requires public disclosure of all shareholders considered relevant and that are not located in a jurisdiction with favourable taxation or under a privileged tax regime; and (2) Brazilian investment funds regulated by the CVM, provided that the Brazilian taxpayer's number of all the shareholders of the funds are duly provided to the RFB by the portfolio administrators. Note that this is a recent obligation and even the authorities remain uncertain in their requests for documents and information.

35 Pursuant to Article 1 of CMN Resolution No. 4,373/14, the provision mentioned aims to determine the guidelines for application of external resources entering Brazil by non-resident investors in the financial and capital markets, and the transfer of funds from and to abroad, in national or foreign currency. According to Article 5, I of this Resolution, non-resident individual or collective investors are defined as individuals or legal entities, funds or other collective investment entities resident, domiciled or headquartered abroad.
36 IN 1,863/2018 was amended by Rules Nos. 1,895 of 27 May 2019, 1,897 of 27 June 2019 and 1,914 of 26 November 2019, and also by COCAD Declaratory Executive Act No. 2 of 30 December 2019, issued by the RFB.
37 Pursuant to IN 1,863/2018, a significant control or influence is presumed whenever the individual (1) holds, directly or indirectly, more than 25 per cent of the entity's corporate capital, or (2) holds, directly or indirectly, the power to control the entity's corporate decisions and to appoint the majority of its managers.
38 IN 1,634/2016 initially established the deadline for the submission of information on ultimate beneficial owners as 31 December 2018. However, IN 1,863/2018 (which revoked IN 1,634/2016) extended the deadline to 26 June 2019 (180 days from the publication of IN 1,863/2018).
Investments made in the Brazilian financial and capital markets through CMN Resolution No. 4,373/14 are subject to favourable income tax treatment. Concerning FIPs specifically, the income arising from investment in these funds and gains arising from the sale or amortisation of FIP shares by non-resident investors that are not resident or domiciled in a favourable tax jurisdiction are currently taxed at zero per cent, provided the following requirements are met (the FIP Requirements):

a. the non-resident investor does not hold, individually or with related parties (as defined by applicable legislation), 40 per cent or more of all shares issued by the fund (shareholding test) nor does it have the right to receive 40 per cent or more of the total income generated by the fund (economic test), and the ultimate beneficial owners must be identified to the CNPJ in accordance with the RFB beneficial-owner requirement (see above); 43

b. the fund does not have in its portfolio, at any time, debt securities in an amount exceeding 5 per cent of its net worth, unless the securities correspond to convertible debentures, subscription warrants or public bonds;

c. the fund is compliant with additional portfolio requirements provided by CVM regulations, which currently require at least 90 per cent of FIP portfolios to be composed of shares, subscription warrants, simple debentures, other convertible securities or securities exchangeable into shares that are issued by corporations (either closely held companies or publicly held companies), as well as securities representing equity participation in limited liability companies, provided that the FIP participates in the decision-making process of the investee companies, with effective influence on the definition of their strategic policies and management; and

39 Section 3 of Law No. 11,312/2006.
40 The FIP may also have Brazilian resident investors, but they will not benefit from this tax incentive.
41 Brazilian law defines more than one concept of favourable tax jurisdiction. However, the concept that matters for this particular analysis refers to foreign investments in the Brazilian financial and capital markets pursuant to CMN Resolution No. 4,373/14. Accordingly, the applicable concept of favourable tax jurisdiction refers to a country that does not tax income or that taxes income at a rate lower than 20 per cent or does not provide information regarding the equity partners of legal entities, its owners or the beneficial owner of the income paid to non-residents. The standard tax rate of 20 per cent to identify privileged tax regimes is reduced to 17 per cent if the country follows the international standards of tax transparency (Ordinance MF 488/14), as established by the RFB. The Brazilian tax authorities have listed some jurisdictions as favourable tax jurisdictions. Historically the tax authorities have viewed this list as being a numeros clausus list, namely any jurisdiction not appearing on the list will not be deemed a favourable tax jurisdiction. Ireland was the most recent inclusion, at the end of 2016.
42 The 40 per cent ceiling applies to the following parties related to individual FIP investors: (1) relatives up to the second degree, (2) companies controlled by the investor or by any of the investor’s relatives up to the second degree, and (3) partners or managers of companies controlled by the investor or the investor’s relatives up to the second degree. Where the investor is a legal entity, the ceiling applies to any entities that are the investor’s controller or are controlled by or affiliated to the investor.
43 Based on the literal wording of the law, one could conclude that the 40 per cent test for fulfilling the FIP Requirements is to be observed solely by the direct investors of the FIP, and not by their shareholders, partners or members (except where the shareholders, partners or members are also direct investors of the FIP), and that there is no need to account for any indirect interests. However, any analysis of the shareholding test and the economic test may be controversial, and one should consider an indirect approach and a ‘substance-over-form’ analysis. The rationale is to avoid using related parties (close individuals and group companies) to circumvent the ceiling of not having 40 per cent or more shares of the FIP.
d in addition to the provision mentioned in item (c) above, at least 67 per cent of the FIP’s portfolio is composed of shares of corporations, debentures that are convertible into shares and subscription warrants (allowed assets). 44

Additionally, under another tax incentive regime 45 and provided that all shareholders are exclusively non-residents, all gains, including capital gains paid, credited, delivered or remitted to beneficiaries resident or domiciled outside Brazil (except if situated in a favourable tax jurisdiction) that are produced by investment funds are exempt from income tax if the following general cumulative requirements are met (but an analysis per asset to be invested is advisable):

a all the shareholders must be exclusively non-residents, with the RFB now requiring beneficial-owner information to be provided to the CNPJ to avoid structures with individuals resident in Brazil for tax purposes as the ultimate beneficial owner, as defined above; and

b the fund regulations must provide that its fund application is made exclusively in:
   • assets required by tax legislation;
   • cash deposits;
   • assets that are also exempt from income tax, or taxed at a zero per cent rate, when the beneficiaries of the gains derived from the assets are residents or are domiciled outside Brazil (except if situated in a favourable tax jurisdiction); 46 or
   • assets traded in financial and capital markets that are exempt from taxation, provided that they are negotiated by the funds under the same terms and conditions set out by law for the enjoyment of the tax exemption.

In addition, foreign exchange transactions carried out in Brazil are subject to the tax on financial operations regarding exchange agreements (IOF) for inflow and outflow. The standard rate is currently 0.38 per cent for most foreign exchange transactions. IOF is levied at a zero per cent rate on the inflow and outflow of remittances into related investments made by non-Brazilian residents in the Brazilian financial and capital markets. There are other specific rates or exemptions that may apply to certain transactions. Although unlikely in the current economic scenario, the IOF rate, because of its regulatory purpose rather than budgetary, may be increased at any time to a maximum of 25 per cent by the government.

The tax aspects can be summarised as follows.

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44 Section 11 of Bill No. 10,638/2018 intends to revoke this requirement (see below).
45 Section 97 of Law No. 12,973/2014.
46 If the fund regulations restrict its shareholders to non-resident individuals only, the fund is also allowed to invest in assets whose gains will be exempt from individual income tax under Section 3 of Law No. 11,033/2004 (e.g., certificates of real estate receivables, real estate investment funds).
Brazil

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Taxes involved</th>
<th>Additional details</th>
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</thead>
<tbody>
<tr>
<td>Inflow of funds as investment in a FIP</td>
<td>IOF: zero per cent</td>
<td>Registration of the investor under CMN Resolution No. 4,373/14. Financial institutions are required to represent the investor and comply with regulatory and tax requirements.</td>
</tr>
<tr>
<td>Amortisation or redemption of FIP shares</td>
<td>IOF: zero per cent</td>
<td>Capital gain is the difference of the amortised value and the corresponding cost of the shares amortised (calculated in reais).</td>
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<tr>
<td>Withholding tax (WHT) on capital gains: in general, progressive table from 15 per cent and 22.5 per cent;* but zero per cent if certain of the FIP Requirements are met.</td>
<td></td>
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<tr>
<td>Sale of shares</td>
<td>IOF: zero per cent</td>
<td>WHT of zero per cent applies on the trading of shares through a stock exchange, even though this is not a common exit strategy for private equity funds; or if the FIP Requirements are met.</td>
</tr>
<tr>
<td>Withholding tax (WHT) on capital gains: in general progressive table from 15 per cent and 22.5 per cent;† but zero per cent if certain of the FIP Requirements are met.‡</td>
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</tr>
<tr>
<td>Dividends from lower-tier companies held by the FIP</td>
<td>IOF: zero per cent</td>
<td>It is possible to argue that dividends paid by the lower-tier company to the FIP and immediately transferred to the investor are exempt from WHT. However, tax authorities have expressed a contrary position and sought taxation of these dividends as a amortisation or redemption of FIP shares.</td>
</tr>
<tr>
<td>WHT: exemption (but taxed when further distributed to the FIP holders as WHT on capital gains).</td>
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</tbody>
</table>

* If the FIP does not follow the investment requirements established by the CVM, as mentioned above, and at least 67 per cent (Section 11 of Bill No. 10,638/2018 intends to revoke this requirement (see below)) of its net worth refers to shares, convertible debentures or subscription bonuses (tax law investment requirement), then the applicable tax rates range between 15 per cent and 22.5 per cent. If only those requirements are met (CVM and tax law investment requirements), the tax rate is 15 per cent. If the CVM and tax law investment requirements and the FIP Requirements are met (see (a) to (d) of the FIP Requirements, above), the tax rate is zero per cent. |

† As above. |

‡ As of 2017, in the case of transactions out of the stock market, progressive tax rates of 15 per cent for gains up to 5 million reais, 17.5 per cent for gains above 5 million reais and lower than 10 reais, 20 per cent for gains above 10 million reais and lower than 30 million reais and 22.5 per cent for gains above 30 million reais will be applicable (Law No. 13,259/2016). |

Companies can distribute profits in the form of either dividends or ‘interest on stockholders’ equity’. Dividends are tax-exempt to the beneficiary but cannot be deducted by the company, while interest on stockholders’ equity is tax-deductible by the company but subject to a flat 15 per cent income withholding tax when paid to the beneficiary (not subject to adjustment on the beneficiary’s tax return).

However, under Michel Temer’s presidency, the federal government tried to change the tax regime mentioned above by enacting Provisional Measure No. 806 (MP No. 806/2017) on 30 October 2017, which introduced substantial changes that entered into force in January 2018, on the procedures related to applicability of income tax due on certain financial investments and the tax treatment of certain Brazilian investments funds. The RFB did not enact any regulations regarding MP No. 806/2017.

To enact provisional measures requires urgency on the part of the executive branch and such measures must be approved by Congress within a period of up to 120 days (suspended during Congress’ recess). During this period, the provisional measure is converted into law (although its provisions may be changed or others included), otherwise it will no longer be valid. The provisional measure may also be rejected.

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47 Michel Temer was the vice president who assumed the presidency after the Senate approved the proceeding to impeach and remove President Dilma Rousseff from the presidency in 2016.
However, MP No. 806/2017 was not even voted on by the Brazilian Congress during its 120-day term and therefore it became invalid on 8 April 2018.

The federal government then introduced Bill No. 10,638/2018 in the Chamber of Deputies, regarding the same matter and using almost the same wording as MP No. 806/2017 in relation to the procedures related to the applicability of income tax due on certain financial investments and the tax treatment of certain Brazilian investments funds. In addition, Senator José Serra introduced Senate Bill No. 336/2018 (using the same wording of MP No. 806/2017) regarding the same matter. Both bills are still under discussion in the Brazilian Congress and, therefore, have not been (and may not be) converted into law.

It is important to mention that any legislation that establishes new taxation or increases the income tax due will only be in force in the next calendar year of its conversion in law because of a constitutional rule in this regard. In our opinion (although some provisions seem to refer only to the moment of taxation), even if converted during 2020, the provisions upon conversion into law will only be in force as of 1 January 2021, so the provisions requiring the taxation on this new basis since 2019 are not applicable yet (note, however, that in our analysis below, we kept the dates as determined under Bill No. 10,638/2018).

Under Bill No. 10,638/2018, it became clear that the new rules aimed at closing a loophole allowing investors to use FIPs as if they were holding companies (property funds) just for tax deferral purposes. To close this tax-planning loophole, Bill No. 10,638/2018 focused on qualifying FIPs according to CVM regulations to establish their tax treatment with the following conditions:

- FIPs qualified as investment entities shall not be taxed as a legal entity, but the sale of any investment shall be considered as a distribution to the shareholders, regardless of effective distribution, being subject to a 15 per cent withholding tax (WHT) based on the amount that exceeds the portion paid in by the investors in the FIP’s capital (deferral will no longer be an option); and
- FIPs not qualified as investment entities but known as property funds shall be taxed as legal entities and subject to corporate income tax of 34 per cent and social contributions of between zero and 9.25 per cent on gross revenues (effective taxation depends on the tax regime and the kind of revenue or gain), in which case the fund administrator is liable for the fulfilment of all tax obligations (including ancillary obligations). However, earnings accrued by such FIPs prior to 2 January 2019 will be considered as paid and subject to a 15 per cent WHT at the investor level.

It seems that the rationale of these new rules is, in the case of property fund FIPs, to tax only the FIP, and in the case of investment entity FIPs, to tax only the investor, but not both the FIP and the investor. However, that is not so clear in the legislation (i.e., it is unclear whether property fund FIP distributions will still be considered tax-exempted dividends) and we await changes in the legislation or RFB regulations for further clarification.

Also, the earnings from FIPs organised and held exclusively by non-resident investors not located in favourable tax jurisdictions and investing under CMN Resolution No. 4,373/14 in

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48 Section 62, § 2 of the Brazilian Constitution.
49 Sections 5, VI and 7 of Bill No. 10,638/2018 and Section 2, § 6, 7 and 8 of Law No. 11,312/06.
50 Corporate income tax (IRPJ/CSLL) and social contributions on gross revenues (PIS/COFINS) will be due by the FIP.
51 Sections 5, VII, 8 and 9 of Bill No. 10,638/2018.
FIPs that follows the FIP Requirements remain subject to the tax-exemption rules mentioned above, but it is unclear whether a FIP that qualifies as a property fund FIP according to CVM regulations will actually be taxed as a legal entity.

In summary, as provided under CVM Instructions Nos. 578/16 and 579/16, FIPs shall be classified as investment entities if the following cumulative requirements are met:

- the fund has a qualified manager, empowered to take discretionary decisions and not required to appoint shareholders as representatives of the invested entities;
- the purpose of the fund is to offer returns through the appreciation of the invested capital;
- the fund evaluates its investments based on the assets’ fair market values; and
- the fund’s by-laws establish clear and objective strategies in relation to divestment.

Moreover, funds classified as investment entities must also have some of the following characteristics (not necessarily all of them):

- more than one direct or indirect investment;
- more than one direct or indirect shareholder;
- shareholders with no influence in the management of the invested entities and not related to the fund’s administrators; and
- investment in entities with which the shareholders had no previous corporate relationship.

Note also that, as of 1 January 2019, the WHT imposition shall be anticipated when funds classified as investment entities are either transformed, merged or spun off. Furthermore, although Bill No. 10,638/2018 was not converted into law in 2018, and its provisions are not yet in force, reorganisations of investment structures may be considered during 2020, to be prepared for the enactment of new RFB regulations once the Bill is converted into law.

IV OUTLOOK

There are certain difficulties in bringing fundraising into Brazil when compared with the existing offshore fundraising possibilities, mainly because of the slowness and bureaucracy regarding offerings, the difficulty for foreigners to understand the Brazilian tax system and the need for the relaxation of certain rules for the private equity industry.

The relaxation of rules begins when the offering is carried out in accordance with CVM Instruction No. 476/09. As previously mentioned, the CVM has amended this regulation to increase the types of securities that it is possible to offer (such as shares and debentures convertible into or exchangeable for shares issued by certain companies), as well as to facilitate access by other companies to this kind of fundraising. Currently, there is a drive in Brazil to increase the funding possibilities for small and medium-sized companies, which typically do not have easy access to the capital markets, making funding more costly to such companies.

To this end, in 2017, the CVM enacted rules applicable to crowdfunding investments for purposes of allowing companies with annual revenues of up to 10 million reais to carry out offerings by means of online platforms of collective financing, without registration of the public offerings.

In addition, the CVM has amended CVM Instruction No. 409/04 (which was subsequently revoked by CVM Instruction No. 555/14, as mentioned below), and created

52 Section 5, IV of Bill No. 10,638/2018.
53 The amendments were made by the enactment of CVM Instruction No. 549 of 24 June 2014.
a new investment vehicle – the stock investment fund – access market (FMA), which is able to participate more easily in the transition of companies from the pre-public offering to the post-public offering stage.

Pursuant to the terms of CVM Instruction No. 555/14, the FMA shall adopt an investment policy under which at least two-thirds of the net assets are invested in shares of companies listed in an access market securities trading segment of a stock exchange or over-the-counter entity, which guarantee, by means of a contractual relationship, enhanced corporate governance practices.

This CVM Instruction also allows FMAs, when incorporated as closed funds, to invest up to one-third of their net assets in shares, debentures, subscription warrants, or other titles or securities convertible into or exchangeable for shares issued by closely held companies, provided that they participate in the decision process of the investee companies and the closely held companies adopt certain corporate governance practices as established in CVM Instruction No. 555/14.

In addition, FMAs, when incorporated as closed funds, may invest in companies with lower liquidity,54 and also repurchase the shares issued by the funds in the organised markets where the shares are admitted for trading, provided that certain requirements regarding the price and amount of shares to be repurchased, established by CVM Instruction No. 555/14, are also complied with.

Through the above-mentioned amendments, the CVM has created a fund with mechanisms that enable investors to participate in the maturing process of private companies by purchasing their shares when they are private companies and accompanying them during the initial public offering and their first years in the market.

Another important example of the relaxation of the Brazilian regulation applicable to investment funds is the enactment of CVM Instruction No. 555/14, which replaced CVM Instruction No. 409/04 on 1 October 2015, establishing new provisions on investment funds, which provided, among other amendments, the valorisation of electronic means of communication, the modernisation of information disclosure and the relaxation of the limits of investment in certain assets, especially financial foreign assets, as well as the creation of a ‘simple fund’, for which the CVM does not require compliance with the procedure to verify the investment suitability of the client’s profile, provided that more than 95 per cent of its net equity is invested in government bonds or bonds with equivalent risk.

As regards investments in foreign assets, a type of fund exclusively directed to qualified investors is now authorised to invest 100 per cent of its portfolio in foreign assets, provided that some other rules established in CVM Instruction No. 555/14 are complied with. In addition, with the creation of the simple fund mentioned above, the CVM intends to incentivise newer and safer opportunities for local players to invest in investment funds. The main goal of establishing the simple fund was to provide a new vehicle type directed at initial investors and formed by low-risk assets, and whose portfolio managers shall have the duty to protect against volatility.

Regarding FIPs, it is important to highlight CVM Instruction No. 578/16, which, as mentioned above, replaced CVM Instruction No. 391/03, and created new rules concerning the formation, operation and management of FIPs. Among the new rules, it is important to mention the creation of seed capital FIPs, emerging company FIPs and multi-strategy FIPs,

54 The provisions related to the FMA mentioned herein have remained in force under CVM Instruction No. 555/14, which came into force on 1 October 2015.
which are allowed to invest in limited liability companies. The creation of these types of FIPs represented an important step for the development of new investments in Brazil, facilitating the funding of start-ups and early stage companies. In addition, general FIPs may now invest up to 20 per cent of their portfolio in foreign assets, provided that the foreign assets have the same economic nature as the assets permitted for investment by FIPs, and multi-strategy FIPs (exclusively directed to professional investors) may invest up to 100 per cent of their subscribed capital abroad, as long as certain other requirements are complied with (see Section II.iv).

Another important development introduced by CVM Instruction No. 578/16 is that FIPs are now allowed to contract loans directly from entities classified as incentive entities, provided that the amounts are limited to 30 per cent of the FIP assets. Such loans may now also be used for the payment of pending shares subscribed and not paid by shareholders.

Furthermore, CVM Instruction No. 578/16 allows FIPs exclusively aimed at professional investors to have classes of shares with different financial and economic rights (in addition to those rights already established in Article 19, Paragraph 2 of CVM Instruction No. 578/16).55 The shares of the same type may also be divided into different categories, with the specific purposes of establishing, for each category, different payment dates and forms of amortisation and compensation. In this regard, the recently enacted Brazilian Economic Freedom Law has also allowed the creation of segregated assets for each class of shares of the FIP. Such new law reflects another example of the relaxation of the Brazilian regulation on the private equity industry, and, among other important provisions, has established the possibility of funds’ by-laws to establish limitation to the liability of FIP shareholders to the value of their shares and also to the obligations attributable to the class of shares held by the shareholders, as well as limitation to the liability of funds’ service providers (e.g., administrators and portfolio managers) to the obligations to be complied with by each of them (without being jointly liable), provided that the rules enacted by the CVM are also complied with.

As mentioned above, the option for FIPs to grant guarantees (initially introduced by the enactment of CVM Instruction No. 535/13, amending CVM Instruction No. 391/03, and retained by CVM Instruction No. 578/16, which revoked CVM Instruction No. 391/03) should, in principle, improve access to debt funding by the private equity industry, allowing financing entities such as the National Bank for Economic and Social Development to become more involved in the expansion of local industry. As previously mentioned, this would facilitate the use of leveraged buyout mechanisms; however, because of the economic crisis and political uncertainty experienced in Brazil over the past years, Brazilian banks have not demonstrated an appetite to provide financing for leveraged buyouts. The scenario is expected to be different for 2020 and the following years. The economic policies drawn up by the new right-wing government have shown signs of economic recovery and development in many ways.

The Brazilian government is promoting the transition to an open and competitive market. In this regard, 2019 was marked by the beginning of a divestment process conducted by the federal government, by means of divestments and privatisations of companies and their subsidiaries previously controlled by the federal government.

In addition, the recent enactment of Resolution No. 16/19 of the National Council for Energy Policy, which promotes principles, guidelines and recommendations for the

55 According to Article 19, Paragraph 2 of CVM Instruction No. 578/16, the FIP’s by-laws may establish different financial and economic rights to one or more classes of shares exclusively in relation to (1) the establishment of administration and portfolio management fees; and (2) the priority in relation to the payment of revenues, amortisation or liquidation balance of the fund.

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transitioning to the ‘new gas market’ has also shown the tendency of the Brazilian government to enhance a competitive and open market. Although there are many regulatory and economic issues to tackle, specialists of the oil and gas industry are certain that the natural gas supply will grow over the next decade, accompanied by investments related to the integration of this sector with the electric and industrial sectors. In relation to the aviation market, recent amendments to Rule No. 7,565/1986 (the Brazilian Aeronautical Code), introduced by means of Rule No. 13,842/2019, have increased the equity participation that may be held by foreign entities in the capital stock of Brazilian airline companies from 20 per cent to 100 per cent. With the opening of the aviation market, Brazil expects to have an increase in foreign investments in local airline companies, which, in its turn will represent an increase of the airline services offered in Brazil, the creation of new employment opportunities and growing competition in the airline sector.

This new landscape is very promising for the private equity industry.

Also, there is still a material demand for investment into several sectors of the economy, including infrastructure, energy, services, technology and the internet, healthcare and medical devices, education and agribusiness, which shows a variety of segments available for private equity investments.

Owing to the relaxation of Brazilian regulation of the healthcare system in 2015 – in particular, allowing foreign investment – there has been an increase in private equity fund investments in this sector since then, especially into hospitals and medical laboratories. In addition, the healthcare system is considered an essential segment, and so, even in periods of economic crisis there is scope for development. Likewise, the innovation of medical devices in Brazil has been attracting the interest of foreign investors. The investment in start-up companies (mainly focused in internet and technology sectors) has also been attracting the interest of foreign investors, especially through corporate venture capital and alternative fundraising mechanisms such as equity crowdfunding. The Brazilian healthcare market has also experienced a verticalisation process in recent years and healthcare operators are building their own hospital network. Many of the highest-valued transactions of 2019 were backed by private equity funds, as was the case in the sale of São Francisco Saúde Group (which had a private equity fund managed by Gavea Investimentos as one of its shareholders) to Hapvida, one of Brazil’s largest healthcare operators, for over US$1.2 billion.\(^56\)

Given the above, we believe that the Brazilian market is very promising for local and global players, especially considering the recent and upcoming reforms, relaxation of CVM instructions related to investment funds (i.e., the creation of simple funds, the new rules for FIPs, especially the possibility of investing in limited liability companies), the equity crowdfunding regulation that has been enacted by the CVM in 2017, the recent enactment of the Brazilian Economic Freedom Law and the reduction of interest rates, as well as of exchange rates that are favourable to foreign investors and that also create a favourable scenario for exporting Brazilian products. In addition, because of the current lack of attractive financing mechanisms for Brazilian companies, private equity funds have become an important capital-raising alternative for Brazilian companies, which are more open to negotiating their assets.

Chapter 3

CANADA

Jonathan Halwagi, Tracy Hooey, Anabel Quessy and Ryan Rabinovitch

I GENERAL OVERVIEW

After the historical heights that fundraising activity in Canada reached in 2017,3 the Canadian private equity market experienced a significant slowdown in fundraising in 2018, with industry reports indicating a potential resetting of the fundraising cycle.4

While industry reports are not yet available for the Canadian private equity market for 2019, we observe a few notable fundraisings, such as the Canadian firm Brookfield Asset Management Inc closing its fifth flagship private equity fund with total equity commitments of C$9 billion in November 2019.5 With its private equity division run out of New York, the launch of this fund tipped US private equity fundraising to an all-time high.6 Also noteworthy was the closing of Altas Partners Holdings II LP, oversubscribed at its hard cap of C$3 billion, also in November 2019.7

The government of Canada continues to support the venture capital industry by contributing to its continued growth.8 In 2018, the government of Canada, through the Business Development Bank of Canada, started implementing the Venture Capital Catalyst Initiative (VCCI), which aims to invest C$450 million in large private sector-led funds-of-funds and in venture capital fund managers to increase the availability of late-stage venture

1 Jonathan Halwagi, Tracy Hooey, Anabel Quessy and Ryan Rabinovitch are partners at Fasken Martineau DuMoulin LLP.
2 This section is based on industry reports available in January 2020. Private equity or venture capital firms in Canada are not required to report their activities; consequently, the industry reports reflect verifiable information only and may not adequately reflect the activities of all private equity or venture capital firms.
capital in Canada. With funds from the private sector, this investment has the potential to inject around C$1.5 billion into Canada's innovation capital market. Through the VCCI programme, 15 emerging and diverse managers were selected during 2018 and 2019, and eight venture capital funds have been launched in relation to this initiative.

II LEGAL FRAMEWORK FOR FUNDRAISING

Common legal structure and key terms

Legal vehicle

As with most other jurisdictions, the selection of the legal structure for private equity funds is driven by tax considerations and liability protection for investors. The most common legal structure used for private equity funds in Canada is the limited partnership as it provides tax transparency (as discussed in Section III.ii) and limited liability to investors.

In Canada, limited partnerships can be established pursuant to the laws applicable in any of Canada's provinces and territories. The legal regime applicable to limited partnerships is generally similar across all Canadian jurisdictions, providing limited liability to investors who do not take an active part in the business of the limited partnership and providing a flow-through tax treatment to its partners.

Each Canadian jurisdiction expresses the concept of not taking an active part in the business of the partnership slightly differently. In Ontario, the Limited Partnership Act (Ontario) provides that a limited partner is not liable as a general partner unless the limited partner 'takes part in the control of the business'. In Manitoba, the Canadian jurisdiction that is generally viewed as offering the widest protection to limited partners, the Partnership Act (Manitoba) provides that the loss of limited liability by a limited partner is caused by the limited partner taking 'an active part in the business of the partnership'. However, unlike other Canadian jurisdictions, the limited liability of the limited partner is not lost with regard to any person who knew that the investor was a limited partner.

Notwithstanding the above, private equity managers typically establish the fund under the laws of the province where they are established and conduct most of their activities. However, other considerations or pressures may come into play when deciding where to establish the fund in Canada. Key anchor investors may pressure the private equity managers to establish the fund in a jurisdiction they are more familiar with or that provides slightly more advantageous language with regard to the limited liability of investors (such as Manitoba, for example, as described above).

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10 ibid.
11 ibid.
13 See Sections 63(1) and 63(2) of the Partnership Act (Manitoba), C.C.S.M., c. P30.
14 ibid.
15 While there is often no specific tax advantage to doing so, when marketing to non-Canadian investors, Canadian private equity managers sometimes choose to establish their funds in offshore jurisdictions that are more familiar to the non-Canadian investors (e.g., the Cayman Islands).
Constituting document

The constituting document used to govern a limited partnership is the limited partnership agreement. The limited partnership agreement provides the terms of the fund, including the fund’s investment objectives and restrictions, the duties and powers of the general partner and the limited partners, the capital call and distribution mechanisms and the fund’s term, termination and liquidation.

While the specific terms of Canadian private equity funds can vary, the terms of larger funds are usually aligned with the prevailing market practice for similar funds established in larger jurisdictions (especially the United States and the United Kingdom). We discuss some of the key terms below.

Life of the fund

Private equity funds in Canada are traditionally established as closed-ended funds. The limited partnership agreement usually provides for an offering period of 12 to 18 months from the initial closing of the fund during which new or existing investors can make new capital commitments to the fund. After the offering period has ended, the fund is no longer open to new capital commitments.

The fund’s life is divided into two phases – the investment period and the management period. During the investment period, which usually ranges from three to five years from the initial closing of the fund, the private equity manager deploys the capital committed by the limited partners by making portfolio investments. Thereafter, during the management period, subject to exceptions, the fund is generally not permitted to make further capital calls for investment purposes. During the management period, the general partner manages the portfolio investments, eventually finding exit opportunities to liquidate the portfolio. The management period usually ranges between four and seven years from the end of the investment period.

A recent trend has seen the establishment of evergreen private equity funds. Unlike the traditional closed-ended funds, evergreen funds do not have a pre-established fund life and are able to raise additional capital commitments on an ongoing basis.

Investment policy, investment restrictions

The fund’s investment objectives, investment strategy and investment restrictions are often detailed in the limited partnership agreement or in one of its schedules.

Common restrictions often include limits regarding the jurisdictions in which investments can be made in, the maximum and minimum size of an investment, the amount of permitted indebtedness and restrictions related to the use of derivatives.

Governance

In terms of governance, Canadian private equity funds usually provide for the establishment of an advisory committee. Typically, limited partners having made capital commitments beyond an established threshold are given the right to appoint members of the advisory committee. At a minimum, the limited partnership agreement usually requires that the advisory committee review any proposed related-party transactions and provide guidance on other issues brought to it by the general partner.
Canada

Some Canadian private equity funds also provide a right to limited partners to remove and replace the general partner. While general partner removal provisions are not uncommon, their specific terms are by no means standard as they are heavily negotiated.

Management fees
Management fees are usually paid to the general partner (or the asset manager appointed by the general partner) in consideration for its management services. Management fees generally range from 1 per cent to 2 per cent of the aggregate commitments during the investment period and from 1 per cent to 2 per cent of the acquisition cost of portfolio investments after the investment period.

Organisational and offering expenses, operating expenses and general partner expenses
The limited partnership agreement also sets out who is responsible for assuming the various expenses incurred by the fund or by the general partner on behalf of the fund. These are often separated into three categories – organisational expenses, operating expenses and general partner expenses.

Organisational and offering expenses cover the establishment and organisation of the fund and the offering, sale and issuance of the interests of the fund. These expenses may include travel and accommodation expenses, and any expenses incurred in connection with the preparation of offering documents (including legal, accounting and filing fees). These expenses are generally borne by the fund up to a cap set by the limited partnership agreement. As a rule of thumb, the cap is usually set at not more than 1 per cent of aggregate commitments to the fund. Any organisational and offering expenses incurred above this cap are borne by the general partner.

Operating expenses cover, notably, all administration costs and expenses (e.g., legal, auditing, consulting, accounting, reporting, bookkeeping, financial, tax, insurance, valuation, contractor and custodial), expenses arising out of the contemplated or realised acquisition, holding, or sale of portfolio investments, and all extraordinary expenses, such as expenses relating to dispute resolution or damages. These expenses are also generally borne by the fund.

General partner expenses, which are commonly borne by the general partner, cover all expenses incurred for the operation and affairs of the general partner (e.g., costs of salaries, rent, fees incurred to promote the fund and to participate in networking events and other fees of the general partner that are not related to the fund).

Carried interest distributions
In addition to the management fees, the general partner (or an entity determined by the general partner) is usually entitled to receive carried interest distributions if distributions made to limited partners exceed their invested capital plus a preferred return (which typically ranges between 5 and 8 per cent). The carried interest distribution usually ranges between 15 and 20 per cent of distributions made beyond the preferred return threshold.

Standard of care
Most of the Canadian jurisdictions do not provide for a statutory standard of care for the general partner in their partnership laws. As such, many partnership agreements include a specific provision providing that the general partner discharge its duties diligently, in good faith and in the best interest of the fund.
Other key documents

Subscription agreement
Investors typically become limited partners by entering into a subscription agreement that sets out the amount of capital the investor is committing for investment in the fund, which is drawn down over time. The subscription agreement also contains representations, warranties and acknowledgements of the investor, notably relating to the accredited investor private placement exemption, residence and tax status of the investor. Investors that are individuals may be required to complete additional documents or will have a specific subscription agreement.

Management agreement
The general partner may delegate its powers to a manager either directly in the limited partnership agreement or in a separate management agreement. The management agreement typically addresses the powers being delegated to the manager, the management fees or other incentive consideration, including carried interest, and indemnification of the manager by the fund.

Marketing documents
One or more of the following documents is usually used to market a private equity fund in Canada – the offering memorandum, the term sheet and the marketing presentation.

The offering memorandum is a marketing document purporting to describe the business and affairs of a fund that is prepared primarily for delivery to and review by prospective investors so as to assist them in making an investment decision in respect of an investment in the fund. It generally includes a description of the offering, the key terms of the fund (including its investment objectives, strategies and restrictions), a description of the business case supporting the fund’s strategy and the risks associated with an investment in the fund. The laws of some of the Canadian jurisdictions provide statutory rights of rescission or damages, or both, to investors if an offering memorandum or one of its amendments contains a misrepresentation, provided these remedies are exercised within the time limits prescribed in each jurisdiction. These laws also generally require that the offering memorandum contain a description of these rights.

The term sheet is a summary of the key legal terms of the fund. A full version of the term sheet is normally included in the offering memorandum, but the term sheet can be used as a stand-alone marketing document, especially if an offering memorandum is not prepared in connection with the distribution of the fund. In some Canadian jurisdictions, term sheets or marketing presentations may be considered ‘offering memoranda’ and as such, may be subject to the statutory rights of rescission described above, including the requirement to include a description of these rights.

Side letters
It is not uncommon for private equity fund managers to provide certain investors with certain rights or preferential treatment by entering into side letter agreements with the investors. The provisions of such side letters alter the terms of the limited partnership agreement between

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Offering memorandums are also commonly referred to as private placement memorandums and confidential information memorandum.
the investors and the general partner. As the side letter is not enforceable against the other limited partners, to be included in a side letter, the provision must not affect the other investors. Examples of rights that are often included in side letters include lower management fees, advisory committee membership, co-investment rights, specific disclosure rights, excuse or exclusion rights from fund investments and most favoured nation provisions.

III REGULATORY DEVELOPMENTS

i Regulatory requirements

From a regulatory perspective, there are two aspects that are important to consider when establishing and distributing private equity funds in Canada – the prospectus requirement and the registration requirements.

The prospectus requirement

In Canada, the issuance of interests in a private equity fund, whether the interests are unitised or not, is considered a distribution of securities.

The securities laws applicable in the Canadian jurisdictions prohibit the distribution of securities unless a prospectus has been filed and receipted by the applicable securities regulatory authority or the fund is otherwise exempt from this prospectus requirement.

The most common exemption from this requirement used by private equity funds is the private issuer exemption. Pursuant to the private issuer exemption, the prospectus requirement does not apply to a distribution of a security of a private issuer if the distribution of securities is made to an investor who subscribes to the security as a principal and is an accredited investor.

A closed-ended private equity fund will generally be considered a private issuer as long as it invests for the purpose of being actively involved in the management of the portfolio entities in which it invests, has restrictions on the transfer of its securities and as long as its securities are held by no more than 50 persons.

Accredited investors are investors that have the required sophistication to understand the risks relating to their investment and can financially bear the risk of losses relating to their investment. The list of accredited investors includes financial institutions, pension funds, government entities, trust companies, investment funds or accounts managed by registered advisers and high-net-worth persons.

Canadian regulatory authorities require that the fund take some steps to confirm the investor can rely on this prospectus exemption.

To the extent that the private issuer exemption is not available for use, the fund may rely on other available exemptions, including one for issuance of securities to accredited investors generally. This requires the filing of a report of an exempt trade.

The registration requirements

Canadian securities laws require that a person not engage in the business of trading in securities unless that person is registered as a dealer; not engage in the business of providing advice with respect to investing in securities unless that person is registered as an adviser; and not act as an investment fund manager unless the person is registered as an investment fund manager.

With regard to private equity funds, the Canadian regulatory authorities have issued guidance that provides that a typical closed-ended private equity fund, its general partner and
its asset manager would generally not be required to register as dealers, advisers or investment fund managers as long as (1) the advice provided by the general partner (or the asset manager) in connection with the purchase and sale of portfolio entities is incidental to their active management of these portfolio entities; (2) both the raising of money from investors and the investing of that money by the fund are occasional and uncompensated; and (3) the fund invests for the purpose of being actively involved in the management of the portfolio entities in which it invests. Examples of active management in a portfolio entity include the general partner (or the asset manager) having representation on the board of directors or a say in material management decisions.

Most Canadian private equity funds fit within the scope of this guidance and, as such, are not investment funds for securities law purposes and are not required to be registered to conduct their activities.

ii Canadian taxation overview

Because private equity funds are typically structured as limited partnerships in Canada, the following is a general overview of the tax implications of such a structure for the funds and its investors.

Fund and Canadian investors

Limited partnerships are generally not subject to Canadian federal income tax. Rather, the general partner calculates the limited partnership's income and losses for each fiscal period and allocates them to the partners. The partners are then required to report their share of income or losses on their income tax returns. Particular sources of income and losses of the limited partnership, including capital gains and capital losses, retain their character when allocated to the partners. Consequently, the limited partnership is transparent for tax purposes and its partners are treated as though they had incurred any income or losses directly.

However, certain limited partnerships are not fiscally transparent. For example, specified investment flow-through tax (SIFT) partnerships may be taxed on some categories of Canadian income, including capital gains. A partnership may be a SIFT partnership if its investments are, or become, listed or traded on a public market.

Non-resident investors

When structuring a Canadian fund that may be offered to investors who do not reside in Canada, managers may want to consider blocking strategies to minimise Canadian tax reporting and tax leakage.

While a non-resident investor in a Canadian fund will generally not be subject to Canadian federal income tax on its share of income from a business carried on by the fund outside Canada, it may notably incur taxes as a result of capital gains resulting from the disposition of 'taxable Canadian property' (TCP) by the fund, or from the disposition of an interest in the fund, if it qualifies as TCP. The following may constitute TCP: Canadian real or resource property; assets used in carrying on a business in Canada; and interests in entities that, at any time in the five-year period preceding the disposition, directly or indirectly derived more than 50 per cent of their value from Canadian real or resource property.

In addition, a limited partnership with limited partners who are non-residents of Canada will be deemed to be a non-resident person for the purposes of Canadian withholding tax. Subject to reductions under an applicable income tax treaty, the withholding rate tax is
25 per cent of the gross amount of the payment. Accordingly, a non-resident investor in a Canadian fund will be subject to Canadian withholding tax on certain Canadian-source non-business income, including dividends and certain types of interests.

**Key changes**

Value added tax may be imposed in Canada. More specifically, a federal component (goods and services tax (GST)) is applied at a 5 per cent rate, while a provincial component may be applied at an 8 per cent or 10 per cent rate depending on the province (collectively with the GST, harmonised sales tax (HST)).

Generally, HST must be paid by private equity funds structured as limited partnerships investing in shares or debt, and typically this tax may not be recovered by way of input tax credits. Distributions to a partner in consideration for its activities as a partner, however, are generally not subject to HST. For this reason, in some cases, a fund’s general partner as opposed to a third-party manager would carry out the management activities (since payments to such a third-party manager would generally have been subject to unrecoverable HST). To address this issue, legislation was enacted in December 2018 to impose HST on the fair market value of management services provided to certain funds by their general partner. The legislation will apply to ‘investment limited partnerships’ (very generally, limited partnerships whose assets consist primarily of financial instruments such as shares, debt, trust units or other partnership interests).

In addition to the above, as HST is not applied in certain provinces, GST is theoretically the only value added tax payable making it more attractive to establish funds in those provinces. To limit this advantage, certain rules that apply to most investment funds impose HST on the basis of the residence of a fund’s investors. However, most funds structured as limited partnerships were not subject to these allocation rules. To address this issue, legislation was enacted in December 2018 to extend the scope of the allocation rules to funds structured as limited partnerships as of 2019.

**IV OUTLOOK**

As previously mentioned, one of the most interesting recent trends in private equity fundraising is the emergence of evergreen private equity funds. Unlike their closed-ended counterparts, evergreen funds do not have a set life and continue until terminated.

This trend is driven both by the desire of managers to have permanent vehicles to manage and pressure from institutional investors who espouse a longer-term investment objective and do not want to be tied to a closed-ended investment cycle. Institutional investors are also attracted by the asset diversification provided by existing evergreen funds. Rather than committing capital to a new structure, an institutional investor committing to an existing evergreen fund can expect, when its capital is called, to participate in the assets already held by that evergreen fund.

The terms of evergreen funds are a hybrid of the terms of traditional closed-ended private equity funds and open-ended funds (mutual funds, hedge funds). In evergreen funds, new and existing investors can make new commitments to the fund any time the general partner opens the fund to new commitments. The investment period is tied to an investor’s specific capital commitment rather than set from the initial closing of the fund.

With all its advantages, evergreen funds face challenges that stem from the illiquid nature of their assets – the exit of investors (redemptions), the valuation of their interests
(for the purposes of subscriptions and redemptions), the structure of the carried interest and the timing of its crystallisation and payment are only a few of the challenges it must tackle and address. While we are still years away from 'market standard' terms for evergreen funds, their popularity with established managers and investors alike is undeniable and both market participants are keen to surmount those challenges.

Another emerging trend in private equity fundraising in light of low interest rates is that Canadian private equity funds are increasingly having recourse to fund-level credit facilities that are becoming more commonly used and are put in place for longer periods and larger amounts. We have seen instances of such credit facilities being used by managers to replace capitals calls at the beginning the fund’s life. It will be interesting to see how fund-level credit facilities will affect current market terms.

Lastly, the secondaries market has flourished in recent years in Canada, as it has in the entire North American market and in the European market, with GP-led secondary transactions continuing to grow in popularity in 2019 with Canadian private equity funds.
Chapter 4

CAYMAN ISLANDS

Nicholas Butcher and Iain McMurdo

I GENERAL OVERVIEW

The Cayman Islands (Cayman) are home to a well-established and ever-growing domicile for private equity funds. This can be seen in the statistics issued by the Cayman Islands Registrar of Partnerships. While a Cayman private equity fund can be established as a company, or indeed a trust, the overwhelming majority of Cayman private equity funds are set up as partnerships to mirror the preferred domestic vehicle of choice; in particular, by US managers and sponsors. Specifically, for reasons that are set out later, private equity funds are typically established as exempted limited partnerships (ELPs) in Cayman. At the end of 2019, there was a total of 28,469 ELPs registered in Cayman. This is a 9 per cent increase on 2018 and more than four times the 2006 number of 6,468. The years since the 2008 financial crisis have seen impressive numbers of annual partnership registrations. However, for the first time, we have seen a decrease in numbers. In 2019, the figure stood at 4,328, compared with 5,007 in 2018, although this is still higher than 2017 and recent years. In 2017, the figure stood at 3,782, in 2016 it was 3,356 and in 2015 it was 3,377.

The reason Cayman has such a well-developed market for private equity funds is a result of its ability to complement onshore fund structures, specifically Delaware partnerships. While founded on Cayman common law principles, which, in turn, are derived from English law, the Cayman Islands Exempted Limited Partnership Law (first enacted in 1991) was drafted to provide symmetry with the corresponding Delaware statute. It has subsequently been amended, but always with a view to dovetailing with the US market. This policy was, and is, simple in design: it was intended, within the confines of Cayman law, to enable a manager’s offshore fund to operate and be governed consistently with its domestic offering. Add to this the fact that while English law is technically not binding on a Cayman court, it is persuasive to it; the Cayman legal environment is at once both familiar and robust. Following a detailed consultation, the Law received a comprehensive review and overhaul in 2014 resulting in a new statute, now the Exempted Limited Partnership Law 2018 (the ELP Law). The ELP Law did not make fundamental alterations to the nature, formation or operation of ELPs, but was intended to promote freedom of contract and simplify transactions undertaken by ELPs.

The statute is not, of course, the only reason for Cayman’s success. The country provides a tax-neutral environment for fundraising, as under current Cayman law, provided its business is undertaken outside Cayman, no taxes or duties, either directly or by way of withholding,

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1 Nicholas Butcher and Iain McMurdo are partners at Maples and Calder, the Maples Group's law firm.
2 As the overwhelming majority of Cayman private equity funds are ELPs, in this chapter we describe the law and practice applicable to ELPs, except where it is also helpful to refer to other structures.
will be levied in Cayman on the trading activities or results of a Cayman-domiciled private equity fund. The combination of practical laws and low fiscal costs has secured the country’s status as a popular and flexible domicile.

This has led to an interesting characteristic of the Cayman funds market: the vast majority of Cayman private equity funds are established by managers that are not themselves resident in the jurisdiction. The Cayman market facilitates the trading activities of the onshore funds industry, and in this sense the trends we see in Cayman are very much a coefficient of the trends experienced or developed in the United States, Europe, Asia and other major markets. The flexibility of Cayman law allows the manager or sponsor to replicate or accommodate deal terms driven by onshore factors and requirements.

If Cayman does not make the market trends, it certainly mirrors them. The lead-in time for deals appears to be currently increasing and, in some cases, lasts for many months. Increased investor expectation for transparency is reflected in a higher prevalence of side letters along with requests for valid and binding legal opinions – previously it was unusual to issue an enforceability opinion with respect to a side letter; now 20 or 30 opinions might be issued on a single closing.

Successful managers are still able to raise significant funds using Cayman structures. Even allowing for the fact that not every Cayman ELP is formed to serve as the investment vehicle for a private equity fund, transactions in the jurisdiction in 2019 remained robust, spanning a wide range of investment strategies and geographic focus.

II  LEGAL FRAMEWORK FOR FUNDRAISING

Prior to 2020, closed-ended private equity funds (i.e., funds in which the capital is locked up for the duration or at least a substantial part of the life of the fund and investors do not have the option to purchase or redeem their interests at their own request) were not required to register with the Cayman financial regulator, the Cayman Islands Monetary Authority (CIMA). This contrasts with open-ended funds, which investors can withdraw at their own option and that have always been required to register with CIMA pursuant to the Mutual Funds Law (2020 Revision). However, in January 2020, Cayman published a bill that will, assuming it is passed into law, also require private (i.e., closed-ended) funds to register with CIMA. Among other requirements, it is expected that the new law will require prescribed details with respect to the fund to be filed with CIMA and for the fund to have its accounts audited annually by a Cayman-based auditor.

Outside of the requirements of this new law once enacted, the legal basis for the fundraising and ongoing investment activities of a Cayman ELP private equity fund is dictated by the contractual relationship established by, and the disclosures set out in, the offering memorandum, subscription agreement and any other ancillary agreement (most notably side letters), and the ELP Law.

The usual legal form of a Cayman private equity fund is an ELP formed under the ELP Law. While a private equity fund can be, and sometimes is, structured as a company (including, since the introduction of a new law in 2016, a limited liability company (LLC)) or trust, the ELP model has two advantages: it allows US managers in particular to use the same vehicle as they do for their domestic offering while preserving freedom of contract through the limited partnership agreement (LPA), and at the same time avoiding the constraints of the maintenance of capital doctrine that applies to a Cayman company.
Maintenance of capital is the price of limited liability for a company. In general terms, it means that the issued capital of a company cannot be reduced or simply returned to investors. The original intention under English law was to enable a concerned investor to carry out a due diligence exercise, based on the enquiry of the company or inspection of public records, to ascertain the capitalisation of a company. That investor could then form its own view as to whether to invest based on the strength of the covenant implied by the size of the company’s share capital. The argument followed that this was an important creditor protection as, given limited liability and separate legal personality, a creditor could, in the usual course of events, only claim against the company, not its shareholders or directors. It therefore followed that the capital needed to be preserved or maintained so that it would be available to satisfy claims. Accordingly, rules, both statutory and common law, grew up to maintain capital, and these are still reflected in modern Cayman company law. For example, a Cayman company cannot reduce its share capital without a court order, special rules apply to the purchase or redemption of its own shares and pure capital (i.e., capital representing the par, or nominal, value of a company’s shares) cannot ordinarily be distributed to shareholders.3

None of these requirements apply to an ELP, as there is no equivalent of the corporate maintenance of capital doctrine under Cayman partnership law. This is because the general partner (GP) of an ELP has unlimited liability for all the debts and obligations of the partnership to the extent that its assets are inadequate.4 Conversely, the limited partners (LPs), as the name implies, are not so liable (subject to two important exceptions noted below).5 This gives investors – the LPs in a Cayman private equity fund formed as an ELP – the best of both worlds: limited liability, but with an almost unfettered ability to receive a return of capital in any situation subject only to the terms of the LPA underpinning the ELP.

An ELP is, in fact, a collection of contractual rights and obligations expressed through the terms of the LPA, which operates under agency principles through the GP and which has a limited liability wrapper for its LPs courtesy of the ELP Law. As the GP both acts for the ELP and has unlimited liability, there are qualifying criteria: at least one GP must be a Cayman company, another Cayman ELP or a natural person resident in Cayman. It can also be an overseas company, including, for these purposes, a Delaware LLC, which registers in Cayman as a foreign company.6 This is short of a migration of the foreign company to Cayman and there is no reincorporation in Cayman, but a registered office is required along with submission of an annual return and, as discussed below, it can then fall subject to certain Cayman laws. Since the overhaul of the ELP Law in 2014, overseas partnerships can also register in Cayman to qualify as the GP of an ELP. There appears to be no overall preference for choice of qualification, although, in the majority of cases, either a Cayman company or a foreign-registered company will be used.7

There are no qualifying criteria for LPs; however, an LP is subject to certain statutory restrictions, again being the price for limited liability. Specifically, an LP is passive. In fact, it

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3 See, for example, Sections 14 to 19 and Section 37 of the Companies Law (2020 Revision).
4 Section 4(2) of the ELP Law.
5 ibid.
6 Section 4(4) of the ELP Law.
7 We should note for completeness that for onshore reasons it is common to see a mezzanine ELP used as the immediate GP to the private equity fund itself, but that mezzanine ELP will itself need a GP, which in turn will typically be one of the corporate models described.
is prohibited under the ELP Law from taking part in the conduct of the business of the ELP, and the law requires that all contracts, agreements and the like are entered into by the GP on behalf of the ELP.8

This leads on to the first of the exceptions to limited liability noted above: in summary, an LP that takes part in the conduct of the business of the ELP can lose limited liability with respect to a third party that deals with that ELP and that reasonably believes the LP to be a GP.9 However, all is not lost for an LP that wants to exert internal control on the activities of the partnership, as the ELP Law sets out a series of ‘safe harbours’, which are deemed not to amount to taking part in the conduct of the business. Probably the most helpful of these is as follows:

consulting with and advising a general partner or consenting or withholding consent to any action proposed, in the manner contemplated by the partnership agreement, with respect to the business of the exempted limited partnership.

This is because this is usually sufficient to enable an LP to participate in an advisory committee of the partnership without concern that it could lose limited liability. This is a potential area for tension for an LP that wants to exert control over a GP, and, therefore, by extension, the ELP itself. We advise that the golden rule for an ‘active passive’ LP is, first, only to participate internally within the partnership, and dealing only with other partners and never with third parties; and second, to have those internal controls expressly documented in the LPA so as far as possible to come within the letter of the safe harbour set out above.

The second exemption to limited liability is clawback on insolvency. If an LP receives a capital – not a profit – distribution and the ELP is insolvent on a cash-flow test at the time the payment is made and the LP has actual knowledge of the insolvency, then that LP can become liable to return the distribution together with interest.10

In short, to complete the description of the legal form of an ELP, the partnership does not have separate legal personality: it contracts through the GP, and property vested into the partnership or expressed to be held in its own name is, in fact, held by the GP. Legal actions would be initiated by the GP on behalf of the partnership. Finally, subject to the terms of the LPA, an ELP can have perpetual succession.

In terms of the fundraising itself, Cayman has a disclosure-based legal system; there are no prescribed rules for the content of an offering memorandum for a closed-ended private equity fund. However, whatever is or is not said may potentially be actionable. In addition to a contractual claim under the contracts constituted by the offering memorandum, the subscription agreement and any ancillary agreement (such as a side letter), liability could also arise under principles of negligent or fraudulent misrepresentation, while the Contracts Law (1996 Revision) could apply with respect to pre-contractual misrepresentation. To complete the line-up of civil claims, an action for deceit could also arise under tort laws. Finally, in the case of criminal deception, the Penal Code (2019 Revision) could apply.11

All this means that the role of adequate disclosure to mitigate the liability of the ELP (along with possibly its GP and promoters), as well as to explain the investment terms,
strategy and risk factors, is crucial. If an investor (i.e., an LP in the context of an ELP) can show reliance on a disclosure in the offering memorandum and breach of that disclosure that has resulted in damage, then a claim could ensue. This applies equally to the adequacy of risk factors, for example, as it does to more readily apparent contractual terms such as a statement as to the quantum of fees to be charged by the GP or sponsor.

Specific Cayman disclosures that might be expected, in addition to the investment narrative, terms and risk factors, include the legal form (and especially that the fund, if an ELP, does not have separate legal personality) and the exceptions to limited liability described above. Also typically included would be a statement with respect to tax treatment, transmission of investor information under regulatory laws (see Section III) and a statement that the ELP is only authorised to carry on business outside the Cayman Islands. This latter point is significant to the parameters for the solicitation of investors in Cayman.

While a Cayman company is not allowed, under the Companies Law, to offer its securities for sale to the public unless those securities are listed on the Cayman Islands Stock Exchange, there is no equivalent for an ELP; however, as shall be seen, an ELP is expressly prohibited from transacting business with the public in the Cayman Islands. In fact, this is what ‘exempted’ in the legal description of an ELP signifies, as only an exempted limited partnership is entitled to apply for the tax-exemption certificate (TEC) described in Section III.

Although there are no equivalents to securities registration statements or investment promotions in Cayman, the legal requirement that the business of an exempted company or partnership must be undertaken outside Cayman means that it cannot generally deal with the public in Cayman (unless, in the case of a company, its securities are first listed on the local exchange). In practice, this means that the investors in a Cayman private equity fund will either be resident overseas or will be other Cayman-exempted entities. One Cayman-exempted vehicle can deal with another, as ultimately their respective businesses are carried out outside, rather than within, Cayman. As the vast majority of Cayman funds are established with exempted status, the restriction does not usually create an issue in practice; however, occasionally a fund will want to take in a Cayman-resident, non-exempt investor. Whether it can lawfully do so will depend on whether the fund has made an offer to the public in Cayman such that it is carrying out business with the public in Cayman.

While specific advice must be sought prior to making an offer in the Cayman Islands, we can extract the following general principles:

- Marketing materials can be sent to a limited number of pre-selected investors;
- Marketing visits should be made on a one-off basis and should be specific to a limited number of pre-selected investors (unless made on a reverse-enquiry basis);
- Local immigration and licensing requirements may apply;
- The fund can be marketed via a website or other electronic means by the sponsor to the extent that the website is not provided through an internet or electronic service provider (e.g., from a server) in the Cayman Islands;
- Unsolicited calls from investors can be responded to, but the making of calls by the sponsor could trigger the public business test;

12 Section 175 of the Companies Law (2020 Revision).
13 Section 38 of the ELP Law.
14 Pursuant to Section 183 of the Companies Law (2020 revision), an overseas company selling securities from the Cayman Islands will first need to register as a foreign company under the Companies Law.
there are no express requirements for the content of marketing materials and, subject to the public offer prohibition, no prescribed minimum or maximum number of offerees; and

it is advisable that the following jurisdiction-specific statement is included in any offering memorandum or equivalent – ‘No offer or invitation to subscribe for [partnership interests] can be made or is made hereby to the public in the Cayman Islands.’

In the vast majority of cases, the sponsor or manager of a Cayman private equity fund will be based onshore, and the fiduciary or other obligations of that sponsor or manager may in part be governed by laws of its own jurisdiction and also the laws of the jurisdiction in which the offer is made; however, the liability, if any, of the sponsor or manager will also be governed by the nature of the contractual arrangements it has with the fund, the scope of its services and obligations, and the extent of any limitation of liability and indemnification. Common carve-outs for exculpation provisions in the context of a Cayman investment fund are fraud, wilful default and gross negligence. Cayman does not have a settled definition of gross negligence, and it is, therefore, usual to see either an express definition or an import of a standard by reference to other laws, usually, in the context of the US market, those of Delaware or New York.

No discussion of fiduciary duties and liability would be complete without referencing the standard for the GP itself. The ELP Law contains a statutory standard that cannot be contracted out of: the GP is required to act at all times in good faith and, subject to the LPA, in the interests of the partnership. There is no statutory standard of fair dealing. While the good faith duty is fixed by statute, the actions of the GP can be subject to contractual limitation of liability and indemnification provisions, although care must be taken to ensure these do not infringe either public policy or common law principles with respect to fiduciary exculpation.

III REGULATORY DEVELOPMENTS

The principal regulatory development of recent times concerning private equity funds in Cayman is the publication of the Cayman Islands Private Funds Bill 2020, which, in summary, and if enacted, will require closed-ended funds to register with CIMA. Previously, only open-ended funds in which investors can withdraw their interests at their own option were required to register.

An investment manager or sponsor domiciled or registered in Cayman as a foreign company, and carrying out investment management or advice, will be subject to Cayman’s Securities Investment Business Law (2020 Revision) (SIBL). This requires that a manager or adviser either be licensed by, or registered with, CIMA. Since 2019, the previous category of ‘excluded persons’ is no longer available and, accordingly, at a minimum, and, apart from as described below when the GP is a ‘non-registrable person’, registration is required. Registration is possible where the person to whom the services are provided (i.e., the private equity fund itself) is either a sophisticated person within the definitions set out in SIBL, or is a high-net-worth person (HNW). As most private equity funds are institutional, the latter

15 Section 19 of the ELP Law.
test is usually relied upon as this sets the threshold for HNWs at US$5 million in total (as opposed to net) assets.\textsuperscript{16} The typical Cayman Islands private equity fund will easily reach this benchmark.

Of course, it is often the case that the GP will provide investment management or advice services to the ELP fund. However, there will be no requirement to register under SIBL, provided it is not separately remunerated for its services other than in its capacity as GP under the LPA and does not otherwise hold itself out as providing such services generally.\textsuperscript{17} In these circumstances, the GP will be a non-registrable person for the purposes of SIBL.

The private equity fund itself will also be subject to certain reporting requirements: if any person resident in Cayman knows or suspects, or has reasonable grounds for knowing or suspecting, that another person is engaged in criminal conduct or money laundering, or is involved with terrorism or terrorist financing or property, and the information for that knowledge or suspicion came to his or her attention in the course of business in the regulated sector, or other trade, profession, business or employment, the person will be required to report that knowledge or suspicion to the Financial Reporting Authority of the Cayman Islands, pursuant to the Proceeds of Crime Law (2020 Revision) of the Cayman Islands, if the disclosure relates to criminal conduct or money laundering, or a police officer of the rank of constable or higher; or the Financial Reporting Authority, pursuant to the Terrorism Law (2018 Revision) of the Cayman Islands, if the disclosure relates to involvement with terrorism or terrorist financing and property. Such a report shall not be treated as a breach of confidence or of any restriction upon the disclosure of information imposed by any enactment or otherwise.

Invariably a private equity fund will be structured as an exempted vehicle in Cayman, meaning that it cannot do business with the public in Cayman. In the context of an ELP, this means that, in return for a fee of approximately US$1,800, it can apply to the government for, and expect to receive, a TEC. The TEC will confirm that no law subsequently enacted in Cayman imposing any tax to be levied on profits, income, gains or appreciations shall apply to that ELP, or to any of its partners, in respect of the operations or assets of that ELP or the partnership interests of its partners. The TEC will also usually confirm that any such taxes and any tax in the nature of estate duty or inheritance tax shall not be payable in respect of the obligations of the ELP or the interests of its partners.\textsuperscript{18}

Currently, the TEC has insurance value only, as under current Cayman law there are no taxes levied in Cayman that would be applicable to an exempted private equity fund. Naturally, investors in the fund will be taxed at applicable local rates when proceeds are repatriated to their own jurisdiction, but there is no first-instance charge to tax in Cayman; however, virtually all funds apply for a TEC.

As will be apparent from the foregoing, there have been no relevant changes in Cayman tax law over the past year, and none are currently expected. Finally, Cayman legislated away the unhelpful decision in the English case of \textit{Mercury}\textsuperscript{19} through changes to the Companies Law. In summary, the judgment in \textit{Mercury} appeared to require physical rather than

\begin{itemize}
\item 16 Section 2 of SIBL. A different definition applies to an HNW natural person.
\item 17 id., Paragraph 2, Schedule 2A.
\item 18 Section 38 of the ELP Law.
\item 19 \textit{R (on the application of Mercury Tax Group Ltd) v. HM Revenue & Customs} [2008] EWHC 2721.
\end{itemize}
electronic closings, which would create obvious impracticalities in the context of modern multi-jurisdictional transactions. The changes to the law effectively allow the contractual parties to determine how agreements will be deemed executed.

The ELP Law was revised in 2014. Principal amendments included:

- enabling the LPA to confirm to whom the GP’s good faith duty is owed in given circumstances;
- confirming that, subject to the LPA, LPs do not owe fiduciary duties;
- simplifying the mechanics for admissions of new LPs and transfers of partnership interests; and
- introducing a short-form dissolution procedure.

Cayman has also adopted, in 2014, a Contracts (Rights of Third Parties) Law, which confers on third parties, via an opt-in requirement, a right of enforcement even if they are not a party to an agreement if the actual contracting parties intend to give that right. In the context of an LPA, this means that third-party rights under an indemnity provision, for example, can be enforced by that third party even though it is not a signatory to the LPA.

Revisions to the ELP Law were introduced in early 2013 to authorise the holding of the register of limited partnership interests other than at the registered office, provided that, on request from the Tax Information Authority of the Cayman Islands, details must be made available at the registered office.20

The European Alternative Investment Fund Managers Directive (AIFMD) came into force in the EU and for adhering Member States of the European Economic Area (EEA) from 22 July 2013 and, subject to limited exceptions, will apply to alternative investment fund managers (AIFMs) of Cayman private equity funds. A number of factors need to be taken into account to determine who is the AIFM, including the performance of portfolio and risk management, and the delegation (if any) of those functions. However, in general, the AIFM will be the GP or delegate investment adviser of the GP. The obligations imposed by the AIFMD vary depending on the location of the AIFM, but it applies equally to non-EEA-based AIFMs marketing Cayman Islands private equity funds to investors in the EEA and to EEA-based AIFMs that perform risk management or portfolio management functions for Cayman Islands funds even if they are not marketing. One requirement of the AIFMD with respect to marketing Cayman alternative investment funds into the EEA is for relevant cooperation agreements to be entered into between CIMA and the EU Member State in which the fund will be marketed. CIMA has now signed cooperation agreements with the majority of EU Member States. In addition to cooperation agreements, AIFMs will also have to comply with reporting, disclosure and asset-stripping and EU private equity rules.21

While a detailed analysis of the AIFMD is beyond the scope of this chapter, marketing activities may be exempted temporarily under transitional rules, or permanently if reverse-solicitation rules apply, the fund has a single investor only or if the AIFM manages closed-ended unleveraged assets of less than €500 million. AIFMs will need to consider carefully the application of the AIFMD to such funds before any marketing or management activities are undertaken in the EEA. At the time of writing, the European Securities and Markets Authority is assessing whether it should recommend extending the AIFMD’s marketing

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20 Section 29 of the ELP Law.
21 See Articles 22 to 24 and 26 to 30 of the AIFMD for further details on the reporting, disclosure and asset-stripping rules.
passport to Cayman Islands private equity funds. Currently, only EEA-domiciled funds have access to this marketing passport, while Cayman Islands funds are marketed pursuant to the relevant EEA Member State’s private placement regime. The private placement regimes allow Cayman Islands funds to be marketed in the vast majority of EEA Member States; however, the passport (if granted) would further enhance distribution options. Amendments to key financial laws consistent with the AIFMD for the purposes of marketing Cayman funds to European investors were brought into force on 1 January 2019.

Cayman has adopted comprehensive automatic exchange of information regimes and reporting financial institutions have both due diligence and annual reporting obligations in Cayman. Both the Organisation for Economic Co-operation and Development’s (OECD) Common Reporting Standard and the US Foreign Account Tax Compliance Act have mandatory application in the jurisdiction. Notifications are made to the Cayman Islands Tax Information Authority administered by the government’s Department for International Tax Cooperation.

In 2017, Cayman introduced a new requirement for a beneficial ownership register. Subject to any available exemptions, companies and LLCs are now required to complete and maintain a beneficial ownership register at their Cayman Islands registered office with a licensed corporate service provider.

In the same year, Cayman introduced the Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations 2017. In summary, these regulations implement in the jurisdiction the model legislation published under the OECD’s Base Erosion and Profit Shifting Action 13 Report (Transfer Pricing Documentation and Country-By-Country Reporting).

Following an overhaul of its anti-money laundering (AML) and terrorist financing regulations (the AML Regulations) in 2017, Cayman continues to revise its AML Regulations to ensure it remains in line with current Financial Action Task Force recommendations and global practice. In summary, the AML Regulations have been expanded in scope to apply to a wider range of Cayman entities; to require the appointment of natural persons as AML officers; and to clarify principles of delegation and reliance in the context of outsourcing the administration of the AML Regulations.

In further response to and compliance with OECD base erosion and profit shifting standards, Cayman has adopted the International Tax Co-Operation (Economic Substance) Law 2020 and associated regulations. This Law brings in reporting and economic substance requirements for certain Cayman entities, with reporting made to the Cayman Islands Tax Information Authority.

IV OUTLOOK

It is fair to say that in the first decade of this century, we witnessed a rise in the formation of successor leveraged buyout funds, with investment periods becoming shorter as sponsors successfully deployed capital in acquisitions. However, in recent years, investment periods have moved back to a more traditional cycle of four to five years. In addition, managers have been seeking to use follow-on investment and recycling provisions to their fullest extent with a view to timing the market on the launch of their next fund. Fundraising conditions (both in terms of fund size and speed to market) remained strong in 2019 and the Cayman Islands continues to be the favoured jurisdiction for fund managers.
The ELP continues to be the favoured vehicle for private equity funds, although 2019 witnessed a decline from the record year of 2018 for the jurisdiction with respect to the number of partnerships formed (4,328 in total, representing a 13.5 per cent decrease on the prior year). However, this exceeds the numbers formed in any other year, including the banner years of 2007, 2008 and 2017, respectively, and augurs well for the future resurgence of private equity fund formation in the Cayman Islands. There is strong interest from the United States and Europe – traditionally significant markets for Cayman – but also increasing interest from Latin America and Asia (notably China, Korea and Japan).

The Cayman Islands regulatory regime with respect to private equity funds is set to change in 2020. Notwithstanding these changes, which are in line with international best practices, it is expected that the private equity industry will continue to grow as the registration process is not expected to be unduly burdensome or costly.

It is a characteristic of the Cayman funds industry, since its first inception, that the country has been able to marry robust laws with a pragmatic commercial approach to business. We expect 2020 to be a busy year for the Cayman Islands legislature and that Cayman will continue to refine its laws to ensure it maintains its preferred status among private equity sponsors around the world. As the Cayman Islands continues to respond and adapt to regulatory changes around the world and improve the laws relating to the investment vehicles preferred by sponsors and investors alike, we expect that the next few years will witness a significant growth in the jurisdiction’s share of the private equity and venture capital fund formation market.
I GENERAL OVERVIEW

The concepts of venture capital (VC) and private equity (PE) were first introduced to China in the late 1980s. Ever since the 1990s, with the rapid growth of China’s economy and the unprecedented expansion of start-ups, investments, and mergers and acquisitions, China’s PE/VC industry has maintained a strong momentum, and the number of PE/VC firms has grown exponentially.

In the early 1990s, foreign PE/VC firms, such as IDG, entered into the Chinese market and dominated China’s PE/VC industry from the late 1990s to 2006. During that period, the majority of foreign PE/VC firms invested via offshore foreign currency-denominated funds in overseas holding companies of enterprises within the territory of China with a ‘red-chip’ structure. They reaped returns via exit in the United States or other overseas capital markets. However, as a result of growing familiarity with the PE/VC industry within China, the emergence of VC investments in China’s technology, media and telecoms (TMT) industries, the development of multi-layered capital markets domestically, and promulgations or amendments of relevant laws and regulations such as the Law on Partnership Enterprises of the People’s Republic of China (PRC), China’s domestic PE/VC firms have been developing rapidly since 2006.
Coincident with this development, and in view of the restrictions on foreign investments and foreign exchanges that put foreign currency-denominated funds at a competitive disadvantage, as well as the freeze on shares of Chinese companies listed overseas on account of some fraud scandals, an increasing number of foreign PE/VC firms started to consider and explore schemes for forming yuan funds and exiting via the domestic capital market.

Since 2010, China’s domestic PE/VC firms and yuan funds have witnessed dramatic developments, with some media describing it as ‘PE fever’. By the end of November 2019, a total of 24,494 private fund managers (PFMs) managing 81,299 private investment funds (PIFs) have been registered with the Asset Management Association of China (AMAC), the self-regulatory organisation of the fund industry in China, with total assets under management of 13.74 trillion yuan.5

II LEGAL FRAMEWORK FOR PE/VC MANAGERS AND FUNDS

China’s PE/VC legislation remains out of step with the country’s burgeoning PE/VC industry and lags behind developments in this sector. VC was not written into China’s legal regime until 1996,6 and for a long time there was no national law regarding the legal status of PE, and no regulation of this area or compliance requirements. Over the past few years, China has adopted a series of significant rules and regulations in relation to the PE/VC industry and a basic legal framework has begun to take shape.

In 2003 and 2005, the Ministry of Foreign Trade and Economic Cooperation (now the Ministry of Commerce) and the National Development and Reform Commission (NDRC) promulgated the Regulations on Administration of Foreign-Invested Venture Capital Enterprises and the Tentative Procedures for the Administration of Venture Capital Investment Enterprises respectively, which established a legal regime for foreign-invested venture capital enterprise (FIVCE) and domestic venture capital enterprise.

In August 2006, the Standing Committee of the National People’s Congress adopted the newly amended Law on Partnership Enterprises and introduced the concept of ‘limited partnership’, the most popular form of PIFs worldwide. With the growing awareness and acceptance among industrial insiders, limited partnership quickly emerged as the primary form of PE/VC funds in the markets.

In December 2012, the Standing Committee of National People’s Congress amended the Law of the People’s Republic of China on Securities Investment Funds (the Funds Law), in which ‘non-public fundraising’ is covered for the first time, and the China Securities Regulatory Commission (CSRC) is authorised to enact relevant rules in practice. The amended Funds Law entered into effect on 1 June 2013. Although the Funds Law specifies that CSRC oversees ‘non-publicly offered’ funds, Article 2 of the Funds Law also provides that the Funds Law shall apply to security investment activities by establishing security investment funds through public or non-public fundraising. Thus, controversies arose over whether the provisions of the Funds Law should apply to PE/VC funds that invest in non-publicly offered equities.

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In June 2013, the State Commission Office for Public Sector Reform issued the Notice on Allocation of Administrative Authorities over Private Equity Funds that officially bestowed upon CSRC the authority for the supervision and administration of PE funds with the aim of protecting the rights and interests of investors.

As the regulator for the entire private investment fund industry, including PE/VC funds, CSRC authorised AMAC to be responsible for the registration of PFM s and record filing of PIFs, and to perform the self-regulatory function over the entire PIF industry. In August 2014, CSRC promulgated the Interim Measures for the Supervision and Administration of Private Investment Funds (the PIF Interim Measures), which established the system of registration of PFM s and record filing of PIFs, defined qualified investor and clarified non-public fundraising and disclosure requirements for PFM s. Later, AMAC released a series of self-regulatory rules, including but not limited to, the Guidance of Internal Control of Private Investment Fund Managers, the Administrative Measures for Disclosure of Private Investment Funds, the Administrative Measures for Fundraising of Private Investment Funds, the Guidance on Private Investment Fund Contracts, the Administrative Measures for Service Business of Private Investment Funds (for Trial Implementation) and the Guidelines on the Administration of Investor Suitability for Fund Raising Institutions (for Trial Implementation).

Nonetheless, the level of legal authority of the existing supervisory and administrative rules remains relatively low as a whole. Against this background, in August 2017, the Interim Regulations for the Supervision and Administration of Private Investment Funds (Draft for Comments) was released by the Legislative Affairs Office of the State Council, and opinions were solicited from the industry. At the time of writing, the Interim Regulations for the Supervision and Administration of Private Investment Funds have still to be released. However, once released, as administrative regulations from the State Council, these will constitute a significant upgrade to China’s private equity industry regulatory regime.

In April 2018, another critical document, the Guidance on Regulating Asset Management Business of Financial Institutions (the Asset Management Guidance), was promulgated by the People’s Bank of China together with the China Banking and Insurance Regulatory Commission (CBIRC), CSRC and the State Administration of Foreign Exchange (SAFE). This document aimed to provide a uniform regulatory regime for the asset management industry in China, and a series of ancillary regulatory documents have been promulgated since. Although uncertainty still exists as to its application to the private funds industry, its influence is undoubted.

III GENERAL COMPLIANCE REQUIREMENTS
PIFs in China are required to comply with various operational requirements. Before engaging in any fundraising activity, PFM s established in China (including PFM s with direct or indirect foreign shareholders) must register with AMAC in accordance with the regulations formulated by AMAC. After the completion of fundraising, PFM s have to register the PIFs managed by them with AMAC under the PFM s’ names.

i PFM registration
Certain conditions must be satisfied to complete the PFM registration. Since February 2016, AMAC has required any PFM applying for registration to engage Chinese lawyers to conduct due diligence investigations into the PFM, to confirm its compliance in all aspects
and to issue a legal opinion. A PFM will not be qualified to be registered unless the legal opinion and other application materials are accepted by AMAC. In November 2017, for the first time, AMAC clearly defined the circumstances under which PFMs will be denied registration in Q&As Related to the Registration and Filing of Private Investment Funds (Q&A No. 14), including illegal fundraising, false statement, engagement in conflicting business, being listed as enterprises with serious illegal and dishonest acts, or discredit of senior executives. In December 2018, AMAC restated the circumstances under which PFMs will be denied registration via a PFM Registration Notice, in which AMAC also listed the main requirements for PFM registration. Basic information of registered PFMs is publicised by AMAC on its official website.

ii Regulations on fundraising

With the rapid growth and development of the domestic PE/VC industry, irregularities in fundraising have emerged. Therefore, regulatory authorities have issued a series of regulations on fundraising, among which the most important are the Measures for the Administration of the Fundraising of Private Investment Funds (the PIF Fundraising Measures) promulgated by AMAC on 15 April 2016, the Measures for the Administration of the Suitability of Securities and Futures Investors (the Suitability Measures) promulgated by CSRC on 12 December 2016, and the Guidelines for the Implementation of the Appropriateness Management of the Fundraising Institutional Investors (collectively with the Suitability Measures, the New Suitability Management Regulations) promulgated by AMAC on 28 June 2017.

The PIF Fundraising Measures explicitly stipulate that only registered PFMs and entities that have obtained a fund distribution licence from CSRC and a membership of AMAC are permitted to engage in private placement of fund interests. The PIF Fundraising Measures also stipulate specific rules and restrictions in fundraising, such as the guidelines on advertisement and promotion, offline or via the internet. On the basis of the PIF Interim Measures, the PIF Fundraising Measures further require due fundraising procedures and fund industry qualification of personnel engaged in fundraising. On the other hand, the New Suitability Management Regulations require managers to formulate a uniform standard to classify investors, design a hierarchical risk-control mechanism, regulate the internal management of sales organisations of fund managers and elaborate specific procedures.

iii PIF filings

Upon completion of fundraising, PFMs must register the PIFs they manage with AMAC, which paves the way for further investment by those PIFs. AMAC places importance on the principle of professional and specialised management for a PFM. When applying for registration, a PFM may only register in one business category (e.g., PE/VC fund manager, private securities investment fund manager) and may only manage PIFs registered as a corresponding type. When registering a fund, AMAC will examine whether the PFM's fundraising activities are in compliance with relevant rules issued by AMAC, including whether the PFM has raised capital from qualified investors for the fund. If an investor is in the form of partnership or other unincorporated form and has not been registered with AMAC, AMAC will ‘look through’ the investor to the ultimate investors to assess whether the ultimate investors are qualified investors.

The Registration and Filing of Private Investment Funds (2019 PIF Registration Notice) issued by AMAC in December 2019 further embodies the terms under the Asset
Management Guidance regarding the operation of PIFs, restating that PIFs shall not be engaged in borrowing or lending activities. According to the Notice, any PIF conducting private lending activities as its regular business, or setting up valuation adjustment mechanisms to engage in disguised loan activities (which separate the PIF’s income from the profits or performance of the invested company) will not be permitted for PIF registration.7

iv Information disclosure
AMAC has promulgated several regulations regarding information disclosure by PFMs and PIFs in the past few years, among which the most important are the Regulatory Measures of Information Disclosure for Private Investment Funds and the No. 2 Guideline for Information Disclosure for PE/VC funds. PFMs are required to update both their own registration information with AMAC and the information filed for the PIFs they manage via an online system periodically or each time a material change occurs. In addition, PFMs are also required to disclose to investors information in relation to PIFs they manage according to fund documents (such as the limited partnership agreement).

v Fund liquidation
PE/VC funds have been booming exponentially since 2009. Since the typical term of a PE/VC fund is seven to 10 years, a large number of PE/VC funds will terminate in the near future. It is a significant task for a PFM to arrange an orderly liquidation of a fund. The liquidation of a PE/VC fund shall follow the stipulations under the Law on Partnership Enterprises (or the PRC Company Law for funds organised as companies) and other related regulations, as well as the terms of the fund documents.

IV DOMESTIC INVESTORS
i State-owned enterprises
State-owned enterprises (SOEs) are a major source of capital for PE funds, and in recent years they have also actively sought to act as the general partner (GP), either by itself or in partnership with other parties.

The participation of SOEs as the GP or limited partners (LPs) in a fund creates myriad issues. For example, SOEs are expressly prohibited from acting as the GP under the Law on Partnership Enterprises. It is unclear, however, what constitutes an SOE for the purposes of this prohibition, and different government authorities apply different standards. According to the definition by the State Administration of Industry and Commerce (SAIC), ‘SOEs’ refers only to wholly state-owned entities, while the NDRC used to consider SOEs to be any type of entity where the direct or indirect aggregate state ownership is no less than 50 per cent. According to Decree No. 32 of the State-Owned Assets Supervision and Administration Commission of the State Council and the Ministry of Finance, released in June 2016, the Decree mainly regulates ‘state-owned enterprises, state holding enterprises, and state-controlled enterprises’, and generally requires that: (1) the enterprise contains

7 For more information on the 2019 PIF Registration Notice, see the following Jingtian & Gongcheng legal commentary: www.jingtian.com/Content/2019/12-26/1453291876.html (in Chinese).
over 50 per cent state capital with the largest investor being an SOE; or (2) the enterprise contains no more than 50 per cent state capital but is controlled by an SOE investor (through agreements or other arrangements) and that SOE investor is the enterprise’s largest investor.

Another important issue is the obligation of state-owned shareholders (SOSs) to mandatorily transfer (for free) up to 10 per cent of the issued shares of their portfolio company to the National Council for Social Security Fund (NCSSF) upon the portfolio company’s initial public offering (IPO) (the Transfer of State-Owned Shares Regulation). Before the end of 2017, a PE/VC fund with over 50 per cent state ownership may be classified as an SOS of a portfolio company seeking an IPO, and the fund would have to transfer a portion of its shares to the NCSSF for free. In November 2017, with the promulgation of Circular Guo Fa No. 49 [2017] (Circular 49), the aforementioned Transfer of State-Owned Shares Regulation was repealed, which was a significant positive change for PE/VC funds. It is worth noting that Circular 49 does not amend other existing regulations related to SOEs. Thus, a PE/VC fund with significant state ownership should consider in advance whether assets held by it will be deemed state-owned assets subject to extra filing, asset evaluation and equity exchange procedures for the disposition of the fund’s assets under relevant rules and regulations.8

ii Government-guided funds

China’s fast-growing PE/VC fundraising activities also benefit from the active involvement of government-guided funds (GGFs) (including, among others, VC investment guidance funds, governmental investment funds and government-sponsored industry investment funds, as defined in related laws, regulations or regulatory policies), which provide a quite considerable amount of capital for PE/VC funds. As most of the GGFs are funded by government-related entities or the government itself with the particular purpose of providing ‘guidance’, GGFs have several unique features: (1) they are usually incorporated for specific purposes, such as to promote innovation and entrepreneurship, support the growth of small and medium-sized enterprises, enhance industrial transformation and upgrading, and encourage development of infrastructure and public services; (2) they focus on a particular policy guidance feature and normally require a very low proportion of non-state-owned capital; (3) they usually attach particular investment restrictions to their capital commitments; and (4) they usually demand a higher priority in the distribution waterfall to secure the return of their investment costs by surrendering certain upside interest.

iii Insurance companies

Chinese insurance companies have been allowed to invest up to 10 per cent of their total assets in both domestic and offshore PE funds and equity of privately held companies since 2012 (at the end of 2018, the total assets of the insurance companies amounted to 18,330.892 billion yuan). Further, since December 2014, insurance companies have been allowed to invest up to 2 per cent of their total assets as at the end of the final quarter in VC funds. PE and VC sponsors seeking insurance LPs are required to meet two sets of somewhat differing criteria. The CBIRC issued the Measures for the Administration of

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8 These include, but are not limited to, the Law of the People’s Republic of China on the State-Owned Assets of Enterprises, the Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises, the Measures for the Supervision and Administration of the Transactions of State-Owned Assets of Enterprises, the Rules on the Evaluation and Management of State Assets, and the Interim Measures for the Administration of Assessment of State-Owned Assets of Enterprises.
Equity Investments by Insurance Funds (Draft for Comments) in October 2018. Although not promulgated officially, this document shows the tendency towards giving insurance companies more discretion and space with regard to their investments in PE/VC funds.

In addition to being permitted to invest as LPs into PE/VC funds, insurance companies are also permitted to sponsor PE funds as a GP. As at the end of November 2019, 22 insurance PE/VC funds had been registered, with total assets under management of 186.310 billion yuan.

iv Banks and NCSSF

The tremendous wealth management funds of commercial banks have always been very attractive to PE/VC institutions. However, as the investment of such banking funds is strictly restricted, the path for PE/VC institutions to raise banking funds is not smooth. Pursuant to pertinent regulations, only wealth management funds of qualified private banks/high-net-worth clients can participate in equity investments. Therefore, for a considerable time, wealth management funds, other than those of qualified private banks/high-net-worth clients, were usually invested in PE/VC funds through trust plans or asset management plans sponsored by other non-bank financial institutions, taking advantage of the vacuum caused by separate regulation of financial institutions. The Asset Management Guidance intends to strengthen the regulation of banks’ asset management business and eliminate such regulatory vacuum by requiring commercial banks to establish independent wealth management subsidiaries to detach wealth management business from other banking business. At the same time, the Asset Management Guidance also indirectly opens another door for banks to carry out broader asset management business. Since the ancillary regulations of the Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks and the Administrative Measures for Wealth Management Subsidiaries of Commercial Banks came into force successively, certain wealth management products of commercial banks have been able to invest in equity assets, including stocks listed and traded domestically, the equity of unlisted enterprises and the beneficiary rights (rights to returns) thereof. Further, a wealth management subsidiary of a bank may also select qualified PFMs to act as its cooperation organisations and invest certain qualified wealth management products in PIFs sponsored and managed by such PFMs, which is undoubtedly a piece of significantly positive news for the PE/VC industry.

For first-tier PE/VC sponsors in China, another deep-pocketed LP to go after is the NCSSF. Since May 2008, the NCSSF has been permitted to allocate up to 10 per cent of its assets to domestic PE funds (investments in offshore PE funds are not yet permitted).

V FOREIGN INVESTORS

The form of fund with foreign participation (either as a GP or investors or both) has evolved over the years.

i Foreign-invested venture capital enterprise

Before the advent of the limited liability partnership (LLP) in China, foreign fund sponsors primarily formed onshore funds in China in the form of an FIVCE under the Administrative Regulation for Foreign-Invested Venture Capital Enterprises (the FIVCE Regulation) promulgated on 30 January 2003. An FIVCE may be set up either as a ‘non-legal-person Sino-foreign cooperative joint venture’ (non-legal-person FIVCE) or as a limited liability
company (LLC or corporate FIVCE). A corporate FIVCE is typically used by one or more foreign fund sponsors to set up an onshore fund exclusively with foreign currency capital, whereas a non-legal-person FIVCE was the popular form for a foreign fund sponsor to pool onshore and offshore capital together, often in partnership with a Chinese fund sponsor.

An FIVCE (whether in non-legal-person or corporate form) is required to have a ‘requisite investor’, which plays a role similar to a GP to a partnership fund. The requisite investor is required to satisfy certain requirements, including, but not limited to, having VC investment as its main line of business; having cumulative capital under management of at least US$100 million (or 100 million yuan in the case of a Chinese investor acting as the requisite investor) in the previous three years; and subscribing for and contributing at least 1 per cent (in the case of a non-legal-person FIVCE) or 30 per cent (in the case of a corporate FIVCE) of the total size of the FIVCE.

An FIVCE is required to have a minimum fund size of US$5 million or the yuan equivalent (in the case of a corporate FIVCE) and US$10 million or the yuan equivalent (in the case of a non-legal-person FIVCE). Each investor other than the requisite investor is required to invest at least US$1 million or the yuan equivalent.

The non-legal-person FIVCE was very popular before the advent of the LLP because it was the legal form closest to an LLP. The FIVCE Regulation allows the investors of a non-legal-person FIVCE to agree that the requisite investor assume joint liability to the FIVCE and the other investors to assume limited liability up to their capital commitments (in contrast, all investors of a corporate FIVCE enjoy limited liability protection). A non-legal-person FIVCE was also allowed to be treated as a tax pass-through entity, similar to a partnership, in which case the income of the FIVCE would not be taxed at the fund level but would be allocated and directly taxed in the hands of its investors. The tax pass-through treatment, however, was not well understood by many local tax authorities, causing many non-legal-person FIVCEs to be unable to enjoy the tax pass-through status in many local jurisdictions. As the LLP form was made available to foreign-invested PE funds in 2010, and the provision granting tax pass-through status to non-legal-person FIVCEs was officially repealed in 2011, the FIVCE became a much less desirable legal form for foreign-invested funds in China.

ii Qualified foreign limited partner and renminbi-qualified foreign limited partner

As discussed in Section II, the Law on Partnership Enterprises was amended in 2006 to permit the LLP form, which spurred the growth of domestic LLPs (DLPs). As foreign investment and foreign exchange is tightly regulated in China, however, foreign fund sponsors and investors had not been able to avail themselves of the new LLP structure until the SAIC promulgated the Administrative Regulations on the Registration of Foreign-invested Partnership Enterprises in 2010 and Shanghai released trial regulations on its qualified foreign limited partner (QFLP) pilot programme in January 2011. The pilot programme opens the door for foreign sponsors to set up onshore funds in China in the form of LLPs and

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9 Beijing, Tianjin, Chongqing, Shenzhen, Qingdao (Guiyang Free Trade Zone), Pingtan, Zhuai and Guangzhou followed suit in adopting their own versions of the QFLP pilot programme, which were all modelled on the Shanghai version. Of all the cities with a QFLP pilot programme, the Shanghai programme is by far the most successful while the Tianjin programme is more time-efficient. It is worth noting that Shenzhen released Circular Shen Jin Guit [2017] No. 1 (New Shenzhen QFLP Rule) in September 2017, which improved the QFLP pilot programme it had formed in 2012.
brings clear advantages over the traditional FIVCE or offshore fund model. In particular, in contrast to an FIVCE, which is now subject to a 25 per cent Enterprise Income Tax (EIT), a QFLP fund as a partnership enjoys tax pass-through treatment at the fund level. In addition, an offshore fund has to go through the time-consuming approval process with SAFE for each of its investments into China, and the portfolio company, which would receive foreign currency capital from the fund, must seek SAFE approval for foreign exchange settlement on each occasion that it needs to use such capital. In contrast, SAFE approval for a QFLP fund is done at the front end (namely, at the time of the fund formation), and foreign currency capital may be converted into yuan directly with the custodian bank in a prompt manner (typically close to one week), thus avoiding the lengthy SAFE approval process for each investment and also saving the portfolio company the trouble of having to seek SAFE approval for foreign exchange settlement. With the promulgation, by SAFE, of Circular Hui Fa [2015] No. 19 (Circular 19) in March 2015, Circular Hui Fa [2016] No. 16 (Circular 16) in June 2016 and Circular Hui Fa [2019] No. 28 (Circular 28) in October 2019, the previous stringent payment-based foreign exchange settlement system for foreign-invested enterprises (FIEs) has been replaced by a foreign exchange settlement system for FIEs where FIEs are allowed to settle foreign exchange-registered capital at their discretion and then make equity investments with renminbi (yuan). Circulars 19, 16 and 28 are intended to put the rest of the country on the same level playing field as the QFLP pilot areas. However, in practice, the QFLP pilot areas are still considerably ahead of the rest of the country in terms of the implementation of these foreign exchange regulations and thus remain the preferred location for foreign PE/VC firms contemplating QFLP fund formation at this time.

For those fund sponsors that have not previously managed onshore funds, a QFLP fund could also bring certain reputational and other intangible benefits. To date, dozens of foreign sponsors have received QFLP licences for their PE funds in Shanghai, including leading PE firms such as Blackstone, Carlyle, TPG, 3i Group, Hony Capital and SAIF.

Over the past few years, three main models have emerged for QFLP funds: (1) the DLP model, where the foreign fund sponsor sets up a wholly foreign-owned enterprise (WFOE) to act as the GP or management company of a DLP and raises capital solely from domestic investors in yuan (as exemplified by the Blackstone QFLP fund); (2) the co-GP–joint venture foreign limited partnership (FLP) model, where the foreign fund sponsor partners up with a Chinese fund sponsor to set up a joint-venture management company and raises capital from both domestic and offshore investors (as exemplified by the Carlyle–Fosun QFLP fund); and (3) the wholly foreign-owned FLP model (as exemplified by the Fidelity QFLP fund). QFLP funds and their management companies are required to include ‘equity investment’ and ‘equity investment management’ in their company names and business scope. Additionally, both the New Shenzhen QFLP Rule, released in September 2017, and the Zhuhai QFLP measures, released in January 2019, explicitly permit a ‘domestic manager managing foreign capital’ model (the New Model), by which a pure domestic fund management institution, subject to certain requirements, may raise funds from offshore investors to establish a foreign-invested equity investment enterprise.

The nature of a QFLP fund as a domestic or foreign fund is also an important issue. Under Chinese laws, it is very clear that QFLP funds under the above-mentioned models (2) and (3) and the New Model are deemed to be foreign investors in terms of their investments and are required to go through the same foreign investment process as an offshore fund (except for the differences in the foreign exchange approval and conversion process as described earlier). However, the nature of a QFLP fund under model (1), above, is less than
clear. According to a written reply from the NDRC to its local counterpart in Shanghai on the classification of the Blackstone QFLP fund in April 2012, it was made clear that the investments by such funds still have to comply with the Catalogue for the Guidance of Foreign Investment Industries (the Foreign Investment Catalogue) (e.g., with respect to the prohibition against and restrictions on certain industries, such as the TMT industry and the culture and entertainment industry), even where the fund is issued a business licence as a DLP rather than as an FLP and the portfolio company is not required to be converted to an FIE. Furthermore, the New Shenzhen QFLP Rule explicitly provides that foreign-funded equity investment enterprises are required to directly invest in portfolio companies in compliance with the Foreign Investment Catalogue. It is worth noting that, since the Foreign Investment Law came into force on 1 January 2020, the foreign investment management regime based on the examination and approval system has been completely removed and replaced by the *ex post* reporting regime for foreign investment, greatly simplifying the foreign investment procedure.

It is very common for foreign sponsors to seek to raise yuan capital exclusively from Chinese investors, namely, under model (1), above. To avoid the time-consuming process of applying for a QFLP licence and foreign investment restrictions, foreign sponsors often choose to set up a pure DLP free from any foreign investment restrictions. To our knowledge, one approach used by certain market participants to structure a pure DLP is to use Chinese nationals (e.g., Chinese members of the team or family members of the relevant principals) to set up a purely domestic LLC and to put a series of contractual arrangements in place between the GP and the WFOE management company. Careful advance legal and tax planning is required to ensure that such contractual arrangements provide effective control over the GP and are enforceable under Chinese laws, and that the economics of the fund (e.g., carried interest and management fee) are structured in a way consistent with the commercial intentions of the fund sponsor.

Another variation of the QFLP fund is the renminbi-qualified foreign limited partner (R-QFLP) fund, where offshore yuan as opposed to foreign currency capital is used to set up the fund. The R-QFLP pilot programme has been less successful, partly because it is subject to additional regulation by the People’s Bank of China with respect to the use of offshore yuan by the fund.

VI STRUCTURING OF OUTBOUND INVESTMENT FUNDS

i Outbound direct investment
In 2016, China witnessed huge growth (an increase of 44 per cent) in outbound direct investment (ODI), even though the Chinese government has significantly tightened the ODI and other outbound investment filing and approval channels on account of significant concerns about capital flee and foreign exchange imbalance. The year 2017 witnessed a significant drop in ODI activities as the government was determined to crack down on the illegal transfer of domestic assets offshore through such activities. Since late 2017, however, with the gradual improvement of the foreign exchange imbalance, the government appears to have been cautiously reopening the door for ODI activities, but at the same time it has also significantly raised the disclosure requirements for ODI approval and record filing by means of a series of new rules from the NDRC in late 2017 and early 2018. These rules include Order No. 11, promulgated by the NDRC on 26 December 2017 and effective since 1 March 2018, which strengthened the supervision of channels for outbound investments.
by detailing the sensitive industries to be regulated and clarifying the requirements regarding ODI application materials. The competent departments involved in the ODI process are mainly the NDRC, the Provincial Development and Reform Commission (PDRC), the Commerce Department, the Provincial Bureau of Commerce and SAFE. Generally, ODI in sensitive projects\(^\text{10}\) must be approved by the NDRC, and for ODI in non-sensitive projects, records must be filed with the NDRC or PDRC or disclosed to the NDRC identifying investors and detailing the method of investment and the investment amount. In addition, in a regulatory first, Order No. 11 places ODI activities by PRC individuals through overseas enterprises under the PRC individuals’ own control and those by enterprises in Hong Kong, Macao and Taiwan within the scope of supervision, which means such ODI activities shall be subject to the approval and record-filing requirements mentioned above.

ii Qualified domestic limited partnership

The qualified domestic limited partnership (QDLP) pilot programme, which originated in Shanghai and was further developed in Chongqing, Tianjin and Qingdao, allows qualified foreign-invested overseas investment fund management enterprises to raise capital from qualified domestic investors to set up overseas investment funds for outbound investments. Approval for the QDLP pilot programme was materially suspended from September 2015 until the end of 2017 following changes in regulatory policies on cross-border flows of foreign exchange. On 24 April 2018, SAFE officially announced the expansion of quotas for the QDLP pilot programme in Shanghai to US$5 billion. Since the resumption of approval of the QDLP pilot programme at the end of 2017, a number of institutions have successively obtained QDLP quotas.

iii Qualified domestic investment enterprise

The qualified domestic investment enterprise (QDIE) pilot programme, which was promulgated in Shenzhen, allows qualified overseas investment fund management enterprises to raise capital from qualified domestic investors to set up overseas investment funds for outbound investments. By the end of 2015, QDIE quotas had been granted to more than 40 enterprises since the implementation of the QDIE pilot programme in 2014, with quotas increasing from the initial US$1 billion to US$2.5 billion. However, approval for the QDIE pilot programme was gradually withdrawn and then materially suspended in 2016. The QDIE pilot programme subsequently appeared to resume

\(^{10}\) According to Order No. 11, Article 13, sensitive projects shall include: (1) projects involving sensitive countries and regions; and (2) projects involving sensitive industries. For the purpose of these Measures, sensitive countries and regions shall include: (1) countries and regions that have not established diplomatic relations with China; (2) countries and regions where war or civil unrest has broken out; (3) countries and regions in which investment by enterprises shall be restricted pursuant to the international treaties, agreements, etc., concluded or acceded to by China; and (4) other sensitive countries and regions. For the purpose of these Measures, sensitive industries shall include: (1) research, production and maintenance of weaponry and equipment; (2) development and utilisation of cross-border water resources; (3) news media; and (4) other industries in which outbound investment by enterprises has to be restricted pursuant to China’s laws and regulations and related control policies. According to the Notice of the National Development and Reform Commission on Promulgating the List of Sensitive Industries for Outbound Investment (2018 Edition), sensitive industries shall include: (1) real estate; (2) hotels; (3) cinemas and theatres; (4) the entertainment industry; (5) sports clubs; and (6) the setting up of equity investment funds or investment platforms with no specific industrial project overseas.
China

at the beginning of 2018. On 24 April 2018, SAFE officially announced the expansion of quotas to US$5 billion for the programme in Shenzhen, matching the quotas for the QDLP pilot programme in Shanghai. While it is understood that QDIE pilot programme cases were approved in the middle of 2018, the recent escalation of the China–US trade war has seen the pilot programme being materially suspended once again.

VII TAXATION

Tax is critical to the fund structuring process in China. As tax rules with respect to PE/VC funds and their partners are less settled, the room for tax planning and the downside for lack of or inappropriate tax planning may be significant.

As in the United States, Hong Kong and a number of other jurisdictions, the tax status of carried interest received by the GP remains less than clear. In the United States, for example, legislative proposals have been raised from time to time to try to redefine carried interest from capital gain to ordinary income since 2006. The risk of carried interest being taxed as service income appeared fairly remote in China until early 2017, when a major New Third Board-listed private equity firm was penalised by a local tax authority for having failed to pay value added tax (VAT) on carried interest. Prudent advance tax structuring during the fund formation process thus became extremely important in this respect.

Under Chinese tax law, dividend income between two LLCs is exempt from EIT to avoid double corporate taxation (inter-LLC dividend exemption). For the same reason, dividend income from a corporate PE/VC fund to an investor that is an LLC (a corporate investor) is also exempt from EIT. Since a fund typically receives most of its income from the disposition of portfolio interests, which is then allocated and distributed to its partners, for a corporate investor it makes no significant difference whether the fund is an LLC or an LLP as far as EIT is concerned, because only one layer of EIT will be incurred, either at the corporate PE/VC fund level or at the corporate investor level.

On the other hand, the form of the fund greatly concerns individual investors. An LLC fund is generally subject to EIT and an individual investor in the fund is generally subject to individual income tax (IIT) at a rate of 20 per cent with respect to investment returns from the fund (i.e., two layers of taxes will be incurred). For an LLP fund, no EIT occurs at the fund level since an LLP is treated as a tax look-through entity in China. However, for a long time now it has been less clear in practice whether investment returns from private funds received by an individual investor are subject to the 20 per cent rate or a progressive rate of IIT ranging from 5 to 35 per cent. The promulgation of Circular Cai Shui [2019] No. 8 (Circular 8) in January 2019 makes it clear for the first time how IIT will be calculated for individual investors in venture capital investment enterprises (VCIEs) in the form of an LLP. Circular 8 stipulates that a VCIE may choose to apply either ‘single portfolio accounting’, by applying a fixed rate of 20 per cent IIT, or ‘annual income overall accounting’, by applying a rate ranging from 5 to 35 per cent IIT. Since a fund in LLC form would be subject to an additional layer of tax (EIT) on its income from the sale of portfolio interests, LLP funds are clearly more tax-efficient for individual investors that directly or, through income-tax-transparent vehicles (such as a fund of funds in LLP form), indirectly invest in the funds.

With the nationwide advancement of VAT reform in China since 2016, the financial industry has been included in the scope of this reform. Subject to different types of investment targets, VAT may be imposed on PE/VC funds on the basis of VAT taxable income (e.g., the bond interest income, and income derived from trading in financial instruments, such as stocks
and bonds). Considering that contractual funds have no legal personality and do not require any tax registration, there were uncertainties as to how the VAT scheme would apply to contractual funds in practice. In 2017, a series of guidance regulations were issued by the Ministry of Finance and the State Administration of Taxation (SAT), which clarified that asset managers are VAT taxpayers for the VAT imposed on asset management products, and a simplified VAT calculation method will apply to the VAT taxable income of those asset management products (including contractual funds) at a rate of 3 per cent, effectively as of 1 January 2018. However, for PE/VC funds in the LLP or LLC form that were subject to clear VAT rules (i.e., 6 per cent) prior to the issuance of these documents, there is still uncertainty as to whether the simplified VAT calculation method at the rate of 3 per cent for asset management products applies.

The taxation of an FLP, or more specifically, its offshore partners, remains unclear. One school of thought among the Chinese tax community was that the withholding tax (WHT) at a rate of 10 per cent applicable to foreign invested enterprises in the form of LLC should apply to dividend income from the FLP to an offshore partner, including carried interest to the offshore GP; the WHT could be reduced to 5 per cent if the offshore partner could avail itself of the reduced WHT pursuant to a tax treaty between China and the jurisdiction of formation of the foreign partner (unless the offshore partner was deemed to have a permanent establishment in China, in which case it would be subject to the 25 per cent EIT). This school of thought, however, has not been accepted by Chinese tax authorities, and efforts of tax advisers to negotiate and convince local tax bureaus to accept a 10 per cent WHT have had little success to date. In practice, given the lack of clear guidance on the taxation of offshore partners of an FLP (such as a QFLP fund), some local tax bureaus have been requiring a 25 per cent WHT on dividend income before it may be repatriated to its offshore partners (without distinguishing between the GP and LPs).

VCIEs that are duly registered with the NDRC or AMAC and angel investment individuals enjoy special preferential tax treatment in several pilot areas in China, pursuant to Circular Cai Shui [2017] No. 38 (Circular 38), with effect from 1 January 2017. If they hold investments in qualified seed or early stage technology enterprises for a period of at least two years, they are permitted to apply 70 per cent of their total investment amount in the qualified enterprises to offset their taxable income, with any excess carried forward to subsequent years. In the case of VCIEs formed as LLPs, the 70 per cent tax benefits could be passed along to their corporate or individual LPs. Circular Cai Shui [2018] No. 55, effective since 1 July 2018 and superseding Circular 38, enabled the rest of the country to enjoy the same VCIE tax treatment policies as the several pilot areas listed in Circular 38.

Based on China's commitment to the mutual exchange with other jurisdictions of financial account information of foreign tax residents, the Administrative Measures on Due Diligence Checks on Tax-Related Information of Non-residents’ Financial Accounts (Announcement 14) was promulgated on 9 May 2017, marking the localisation of the Common Reporting Standard in China. Pursuant to Announcement 14, as from 2018,

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11 The pilot areas include Beijing, Tianjin, Hebei, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xi’an, Shenyang and Suzhou Industrial Park.
12 Circular 38 has since been abolished by Circular Cai Shui [2018] No. 55.
13 These commitments were made by China when signing the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information in tax matters with the Organisation for Economic Co-operation and Development in December 2015.
financial institutions, including PFM and PIFs, shall identify the tax-resident identity of the holder or relevant controlling person of any account, identify non-resident financial accounts, and report account-related information to the SAT.

VIII OUTLOOK

As a concept learned from the Western world, the PE/VC market in China has grown at a phenomenal rate over the past 20 years and has helped create many of the leading Chinese companies and global technology giants, such as Tencent and Baidu. At the same time, this phenomenal rate of growth has also caused myriad business and legal issues, some of which are unique to China. As more and more Chinese laws and regulations have been promulgated, the whole regulatory system has continued to lag seriously behind the development of the industry in many respects and has remained characteristically vague in relation to many other aspects of this sector. Regulators are working hard to play catch-up while protecting their own turf. It is a most dynamic market – one in which the law changes much faster than it does in other developed countries, and in which great opportunities and great challenges coexist.

14 ‘Non-resident financial accounts’ refers to the financial accounts opened or maintained by China’s domestic financial institutions and held by non-residents or passive non-financial entities with non-resident controllers.
GENERAL OVERVIEW

In 2017, private equity fundraising remained at almost the previous year’s level at €2.98 billion, as reported by the German Venture Capital Association (GVCA) in its annual yearbook. About half of this total referred to venture capital funds. Venture capital fundraising increased slightly from €1.33 billion to €1.49 billion. On the other hand, the fundraising of buyout funds with €0.94 billion was around 35 per cent lower than its value by the end of the past year. Investments into Germany-based portfolio companies increased to €11.31 billion, which is about 67 per cent more than in the previous year. Seventy-nine per cent of these investments were made into buyouts. Venture capital investments (seed, start-up, later-stage venture capital) remained broadly unchanged and amounted to €1.05 billion.

The German tax and regulatory environment has become even more challenging for private equity funds (namely on account of BEPS, FATCA/CRS, the Investment Tax Reform Act, VAT on management fees, tax transparency and permanent establishment issues, rumours regarding future restrictions of the German capital gains tax-exemption regime, and carried-interest taxation issues).

Private equity funds and other alternative investment funds (AIF) are regulated in Germany pursuant to the German Capital Investment Code (KAGB) that implemented the Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD) into German law. In Germany, not only the national investment regulation has been revised to transpose the AIFMD, but the existing product regulation of the abolished previous German Investment Act has been extended to include closed-ended funds and alternative assets in the KAGB.

The KAGB and its interpretation by the German Federal Financial Supervisory Authority (BaFin) are often more restrictive than the national legislation implementing the AIFMD in other countries of the European Union. Therefore, an increasing number of German fund managers have begun to establish more teams with an international focus and offer non-German fund structures, either onshore (i.e., Luxembourg, the Netherlands, Ireland) or offshore (i.e., Guernsey, Jersey) to German investors. Compared to countries such as the United Kingdom, France and Italy, German private equity funds do not achieve billion-euro commitments. Billion-euro allocations for German investments are more likely to be integrated into pan-European private equity funds with strong German advisory teams.

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1 Felix von der Planitz is a partner and Natalie Bär and Maxi Wilkowski are senior managers at PwC. The information in this chapter was accurate as at March 2018.

2 The OECD (2013) Action Plan on Base Erosion and Profit Shifting (BEPS) was published in July 2013 and identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement these actions.
In terms of asset classes, the trend of the preference of German institutional investors continues to shift from classic buyout to debt funds, infrastructure funds, renewable energy funds and other real asset funds (i.e., timberland) that aim to generate an ongoing yield. Based on a survey conducted by the GVCA, institutional investors in Germany are highly satisfied with their involvement in private equity and have recently expanded their investments in the private equity sector, and are planning to increase their commitments in the future.3

In terms of investors, most of the newly raised capital has been provided by individual investors and family offices as well as institutional investors (in particular German insurance companies, pension funds and pension schemes). Institutional investors are often entitled to a beneficial taxation of capital gains (95 per cent exemption for many corporate investors, tax exemption for pension funds, flat tax rate of 25 or 40 per cent exemption for individual investors). However, the former 95 per cent dividend exemption was abolished for dividends that German or non-German corporations would receive from minority shareholdings (less than 10 per cent). On the subject of the flat tax regime, whether it should be abolished in the future is currently being discussed at the political level.

II LEGAL FRAMEWORK FOR FUNDRAISING

In Germany private equity funds are generally regulated according to the KAGB, which entered into force in 2013 and has transposed the European AIFMD into German law. The KAGB is applicable to AIF domiciled or distributed in Germany and – with respect to the implementation of the AIFMD – also provides for a regulation of Germany-based fund managers or those that provide their services via using the European passport (freedom to provide services in another Member State).

In this section, no distinction is made between AIFs that are internally managed and AIFs that are externally managed. In practice, however, an internally managed fund, namely a fund that does not appoint an external manager but rather manages itself and obtains authorisation as an alternative investment fund manager (AIFM), is generally the exception as regards German AIFs. However, one has to consider that an external AIFM must have a certain legal form as stock company (AG), limited liability company (GmbH) or limited partnership, where the general partner is a limited company (GmbH & Co KG).

i German limited partnership

The most common German fund structure for private equity funds is a German limited partnership (KG) (referred to as an ‘investment KG’ in the KAGB). In this respect, German law principally follows the Anglo-American limited partnership-type fund structures.

The general partner can be a German limited company (GmbH) or even another German limited partnership (e.g., a GmbH & Co KG). Given the illiquid nature of private equity-related investments, it is in principle not possible to set up a private equity fund as open-ended. Shares in a closed-ended investment KG may according to the KAGB only be held by (semi-)professional investors directly. A trustee arrangement may only be used in the case of a closed-ended retail investment KG, whereby the agreement must limit the activity of the fund to the investment of raised capital and management of the held assets (no operative

or commercial activities). The fund must have a defined investment policy additionally to the limited partnership agreement. In principle, an investment KG partnership agreement will appear to be quite similar to an Anglo-American limited partnership agreement, although the KAGB requires certain specifications. Both the limited partnership agreement and the investment policy, as well as any marketing documents, have to be notified to and, in the case of retail funds, be approved by BaFin.

For legal purposes, the German limited partnership is quite competitive with those of other jurisdictions.

However, German partnership law provides for some tax-driven adjustments. The main legal differences of a German limited partnership agreement compared with a limited partnership agreement under English law are as follows:

a no loan commitment – as opposed to an English limited partnership, a German limited partnership agreement would not have to provide for a loan commitment. Instead, the commitments of the limited partners to the capital of a German limited partnership would be divided into a small capital contribution and a large preferred capital contribution;

b managing limited partner – in addition to the general partner, a limited partner (GmbH, an individual or another German limited partnership) would be entitled to certain management responsibilities. The managing limited partner concept is mainly tax-driven and aims to achieve the qualification of an asset management partnership (non-trading) rather than a trading partnership, and in particular to avoid a permanent establishment and thereby tax filing obligations in Germany; and

c priority profit share – the German limited partnership would provide for a priority profit share to be paid to the general partner or the managing limited partner, or both, rather than a management or performance fee. This is again tax-driven to achieve certain VAT advantages, if possible. In practice, it is difficult to obtain a VAT exemption; therefore, Germany is not competitive compared with a Luxembourg partnership structure or – for instance – funds on the Channel Islands. However, if a fund qualifying as an AIF is externally managed, it can be assumed that a significant share of income paid to the fund manager must be classified as a management fee, given the activities that must be performed by the AIFM from a regulatory perspective.

ii German partnership limited by shares

Another local fund structure is the German partnership limited by shares (KGaA), which is comparable with a Luxembourg partnership limited by shares (SCA) because in both structures the limited partners (investors) qualify as shareholders in a corporation that would receive dividends. In practice, a KGaA used to be most suitable for German-resident investors because they were able to benefit from the relevant dividend exemption regime (i.e., 95 per cent corporate tax exemption for corporate investors). This benefit largely vanished with the sunset of the participation exemption for investors with a shareholding of less than 10 per cent. The rules on minority shareholdings do not yet jeopardise the capital gains tax exemption, which is currently under discussion. For non-German resident investors, the KGaA was already in a non-tax-efficient structure. Managers of domestic KGaA should therefore consider restructuring (e.g., form change) into other legal forms.
iii The German Capital Investment Code

Scope of AIFMD/KAGB regulation

In general, all EU-managers of AIF are subject to the European AIFMD regulation. As mentioned above, the KAGB has implemented the AIFMD into German law. In this respect the KAGB provides for rules regarding the authorisation and regulation of the management company. Additionally, the KAGB provides for a specific product regulation regime referring to German AIF and states the requirements for the distribution of fund shares in Germany.

Manager regulation

Fund managers regulated by the KAGB have to apply for authorisation by BaFin to conduct their business. The regulations require the implementation and specification of many functions, especially portfolio and risk management, but also the depositary function, the valuation function, compliance, internal audit, delegation, liquidity management, transparency and remuneration policies by the AIFM. Further, the AIFM must fulfil capital and substance requirements.

The KAGB has implemented certain rules that go beyond the European AIFMD regulation. One important example is the valuation of the AIF’s assets.

Under the AIFMD the AIFM has to implement a valuation function that can be delegated to an external evaluator or – if certain requirements are met – internally conducted by the AIFM itself.

German legislation, however, differentiates between the pre-acquisition valuation (to ensure fair value valuation and market conformity of the transaction) and ongoing valuation for purposes of accounting and net asset value calculation. To ensure investor protection, German retail funds are subject to mandatory external pre-acquisition valuation.

Typical private equity fund assets, namely, private equity investments, co-investments or units or shares in AIF (target funds), may only be acquired when they are previously valued as follows: for assets of a value up to €50 million by one external evaluator, or for assets of a value of over €50 million by two external evaluators who perform the valuation of the assets independently of one another.

The external evaluator performing a pre-acquisition valuation may not also perform the annual (ongoing) valuation of assets during the holding period. All external evaluators must meet certain independence criteria. They may perform the function of external valuation for a maximum period of three years. The income of external evaluators resulting from their services provided to AIFMs may not exceed 30 per cent of their total income in their financial year. In addition, an AIFM may appoint the external evaluator again only after a two-year cooling-off period.

Beyond that, external evaluators must undergo a due diligence process according to the AIFMD regulations, and must be notified to BaFin. The performance of the ongoing valuation by an external evaluator qualifies as a delegation arrangement (as it is included as a function that an AIFM will generally perform in the course of the collective management of an AIF as defined in Annex I of the AIFMD) and must be treated as such.

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4 This is different for EU fund managers that would like to enter the German market cross-border, for example; then the European passport rules for fund managers apply.
Product regulation

Differentiation between open-ended and closed-ended AIF

The AIFMD and the KAGB differentiate between open-ended and closed-ended AIF.

The distinction of whether an AIFM manages open-ended or closed-ended AIF is important, because the AIFMD and the KAGB require the AIFM to comply with particular requirements depending on the type of AIF it manages.

According to the European delegated regulation on the regulatory standards for determining types of funds, an open-ended fund is any fund whose units or shares are, at the request of any of its shareholders or unitholders, repurchased or redeemed prior to the commencement of its liquidation phase or wind-down, directly or indirectly out of the assets of the fund. (However, a decrease in the capital in connection with distributions will generally not qualify a fund as open-ended.) Closed-ended funds are all other non-open-ended funds.

German product landscape

The KAGB has introduced a reform of the entire German product landscape, with restrictions on asset types for retail funds and specific product rules regarding open-ended and closed-ended special funds with professional and semi-professional investors.

The product rules of the KAGB also provide for a ‘restriction of legal forms’, meaning that a closed-ended fund has to be structured either as a closed-ended limited partnership or as an investment stock corporation with fixed capital. The latter vehicle would most probably be seldom used because of tax inefficiencies. This restriction of legal forms represents a theoretical disadvantage given the variety of other EU vehicles; however, the private equity industry should be able to accept the limited partnership structure as it is the most common legal form used in Germany anyway.

It is possible – exclusively for professional and semi-professional investors – to launch a German open-ended special fund that is generally allowed to invest in illiquid private equity assets using as a legal form either an open-ended limited partnership, an open-ended pool of separate assets or an open-ended investment stock corporation with variable capital. However, open-ended special funds for professional and semi-professional investors must be invested according to the principle of risk diversification and must provide for an (overall) asset portfolio with a liquidity profile that is in line with its redemption clauses.

Closed-ended retail funds provide for a specific catalogue of eligible assets; namely, an AIFM may only invest for a closed-ended retail AIF in tangible (real) assets; shares in public-private partnerships; shares in holding companies that may only acquire said tangible assets; participations in companies that are not admitted to trading on a stock exchange or traded on an organised market (private equity investments); units or shares in target AIF with similar investment policies; and some liquid assets and financial instruments. In addition, closed-ended retail funds must among others always be invested according to the principle of risk diversification and may only borrow up to a certain percentage calculated with respect to the fund’s aggregated capital paid in by the investors.

The contractual terms of retail funds must be approved by BaFin, whereas the contractual terms of special funds for professional investors need only be notified.

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Marketing rules under the AIFMD and KAGB

Definition of marketing and distribution

The KAGB does not differentiate between private placement and public offering, but defines marketing and distribution as any direct or indirect offering or placement of fund shares to any type of investor. As an exception, if the distribution of the fund shares to professional or semi-professional investors in Germany does not take place at the initiative of the AIFM or on behalf of the AIFM (reverse solicitation), it does not qualify as marketing within the meaning of the KAGB. However, this reverse solicitation exemption is not stated in the law and is only common understanding of the Regulator. Hence, this approach should be handled very carefully and bears risks.

Notification process for marketing funds

In Germany, the notification process with BaFin is required for all funds to be marketed. This process is particularly burdensome for non-EU AIFMs. Until the implementation of the passport regime for non-EU AIFMs, a non-EU fund manager must provide sufficient evidence of compliance with the AIFMD and the KAGB respectively when applying for permission to market in Germany.

Every non-EU or EU AIFM has to go through a notification procedure with BaFin to market an AIF in Germany (inbound marketing). Minimum requirements of the notification letter are as follows:

a. a business plan, including information on the AIF and the specified domicile of the AIF;
b. contractual terms and legal documents of the AIF;
c. name of the depositary; and
d. a description of the AIF and all required information to be disclosed to investors (e.g., prospectus and key information document).

In addition, when marketing, the AIFM must use safeguards to prevent the marketing of special funds (set up exclusively for professional and semi-professional investors) to retail investors, such as notes in the prospectus, separate and restricted website portals, and relevant obligations in contracts with distribution partners.

As a prerequisite for marketing to German retail investors, the fund must be fully compliant with the KAGB regarding, inter alia, eligible assets, structure, investment restrictions and valuation.

Under the AIFMD passporting regime authorised EU fund managers will notify their national competent authorities (NCA) that they wish to market a fund to professional investors in another Member State of the EU and supply the required documents. Their NCA in turn contact the NCA of the targeted Member State to inform it of the intention to market. EU AIFMs authorised under the AIFMD must supply additional information on the KAGB-conformity of the fund if marketing to retail investors.

As a practical matter, the definition of marketing within the meaning of the KAGB depends generally on the existence of a specific AIF, namely an AIF that has been launched or trades under a definite fund name or whose contractual terms are definite and fixed. Consequently, AIFMs have to be careful in the pre-marketing phase to plan the timing of the notification process, which for a non-EU AIFM or a non-EU AIF may take a longer time.
Client classification

Given the fact that funds for professional and semi-professional investors are regulated less restrictively because of the lower level of consumer protection required compared to that for retail clients, it is necessary to decide in the pre-marketing phase which group of clients the fund shall be marketed to.

As a basis, the AIFMD has adopted the EU-wide applicable Markets in Financial Instruments Directive 2004/39/EC (MiFID) client categories, namely, the professional and retail client definitions used to achieve harmonised consumer protection in investment services.

To allow investors that are, for example, institutional but not professional to invest into professional funds, the KAGB has introduced a new client category – the semi-professional investor. With the introduction of the semi-professional investor the KAGB clearly deviates from the AIFMD and allows certain retail investors to be treated as professional investors – even if they cannot be upgraded under MiFID6 criteria. This is good news for clients whose classification is disputed, such as trusts, foundations or family offices.

However, a retail investor may only be treated as a semi-professional investor if it fulfils the requirements that justify the lower level of protection. This is assumed to be justified if it makes a minimum investment of at least €10 million. Depending on who distributes, either the AIFM or its distribution partner is responsible for classifying the client.

For investments below the €10 million threshold, the AIFM (or its distribution partner) must ensure that the investor commits to making an initial single minimum investment of €200,000 in the AIF in question, an exemption threshold previously set out in Article 2 of the Capital Investment Act. This is to prove that the investor has sufficient financial resources to back its allocated risk appetite.

In addition, as with Article 6 of the EU Regulation on European venture capital funds (EuVECA),7 the investor must state in writing, in a document separate from the contract to be concluded for the commitment to invest, that it is aware of the risks associated with the envisaged commitment or investment.

The AIFM (or its distribution partner) has to assess and obtain evidence that the investor has the expertise, knowledge and experience to independently assess the risks involved with the investment in the fund. If possessed of the relevant qualifications, the investor is deemed able to judge the suitability of the investment for itself. This, however, is based on the assumption that the investor is not as well versed in market knowledge and experience as the professional investor as defined under MiFID II.

If the AIFM (or its distribution partner) believes that the investor is able to make investment decisions itself and thus understands the inherent risks, and that the commitment is appropriate for the investor concerned, then the AIFM (or its distribution partner) must confirm in writing that the assessment has been performed and that these requirements have been met.

Cross-border marketing implications

As the semi-professional investor is, from a MiFID II perspective, a retail client, funds containing semi-professional investors must be treated as retail funds and are subject to the national legislation of the individual Member States on marketing to retail investors.

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The possibilities of marketing these funds may be restricted if they are not compliant with the national legislation in question or if inbound notification procedures are not complied with. In addition, other Member States will most likely not foresee an outbound notification procedure for marketing to German semi-professional investors.

iv The German Venture Capital Companies Act

German private equity funds may consider registering under the German Venture Capital Companies Act (UBGG), which was introduced in 1998 and remains in effect even under the KAGB. Both laws are simultaneously applicable if the requirements are met and provided current activities are not grandfathered. KGs, KGaAs, GmbHs and AGs are eligible as a ‘UBG fund’. The UBGG provides for partial tax transparency because UBG funds are exempted from German trade tax. However, UBG funds are restricted to a series of certain quotas that mainly aim to exclude holding companies from the benefits of the UBGG. For example, a UBG fund must not acquire majority shareholdings (i.e., not more than 49 per cent of the voting shares, subject to certain generous exemptions). In addition, the UBG fund must not invest more than 30 per cent in investments outside the EU or EEA. These restrictions practically limit the relevance of the UBGG mainly to a number of regional German mid-cap funds. However, the UBGG may be an interesting alternative for a German mezzanine fund, mid-cap fund or fund of funds.

v The EuVECA

Since 2013, the EuVECA has been directly applicable in all Member States to venture capital funds that are neither UCITS nor exceed the thresholds of the AIFMD, and where the AIFM (internal or external) is therefore only subject to registration with the NCA. The Regulation includes measures to allow qualified venture capital managers to market their funds to investors across the EU under a new ‘European venture capital fund’ label. The EuVECA sets out the requirements relating to the investment portfolio, investment techniques and eligible undertakings a fund must comply with. It also establishes categories of investors the funds may target; professional investors according to Annex II MiFID, or other investors that commit to investing a minimum of €100,000 and state in writing, in a separate document from the contract to be concluded for the commitment to invest, that they are aware of the risks associated with the envisaged commitment or investment.

III REGULATORY DEVELOPMENTS

On account of Brexit there will be changes in the European regulatory environment. UK or German entities currently using the European passport will have to change their actual structure. If the United Kingdom leaves the EU, we strongly expect that the European passport procedure for fund managers will no longer apply, as the United Kingdom will be regarded as a third country.
Moreover, because of the implementation of MiFID II, which mainly affects the German Securities Trading Act and securities trading firms there will be changes to the KAGB, too, especially for German fund manager (branches or separate legal entities) that provide services or non-core services as defined by the AIFMD.

IV TAX DEVELOPMENTS

The issues below, which might be relevant for fund taxation, have been addressed in the draft of the coalition agreement between the Christian Democratic Union, the Christian Social Union and the Social Democratic Party in February 2018:

a. abolition of the flat tax regime on interest income through the establishment of a functioning automatic exchange of information;
b. new initiatives should be developed together with France to adapt to the changes and challenges arising at an international level, including those involving the United States;
c. support for a common tax base and for the introduction of minimum business tax rates at a European level;
d. amendment of the Foreign Tax Act to meet modern demands;
e. introduction of a financial transaction tax at a European level;
f. more measures to combat tax evasion, tax avoidance, unfair tax competition and money laundering on a national, European and international level;
g. implementation of obligations made under OECD BEPS;
h. implementation of the EU Anti-Tax Avoidance Directive; and
i. adaption of the interest-limitation rules and the introduction of regulations for hybrid entities.

The following issues have already been discussed in previous years but remain on the agenda for 2018 or even later:

a. in keeping with similar practice for dividend taxation, abolishing the 95 per cent exemption on the sale of portfolio shareholdings (less than 10 per cent) has been suggested;
b. the beneficial treatment of the carried-interest taxation might be abolished. Currently, the tax law provides for a beneficial tax regime that allows it to exempt 40 per cent of carried interest from taxation (see below); and

c. there is a discussion on the abolishment of the solidarity surcharge.

Another reform effort that is worth mentioning is the promotion of venture capital in Germany to be internationally competitive as a location for venture capital investment. During the most recent legislative period the government launched measures to improve conditions for venture capital, as envisaged in the coalition agreement; however, new legislation was not adopted. How the reform will develop under the new government remains to be seen.

For each of these initiatives and legislative changes, private equity funds will have to carefully consider their acquisition structures for potential current and future tax exposures, and private equity managers will have to be more coordinated when structuring their investments in future.

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The German Investment Tax Act

The new fund tax rules came into effect on 1 January 2018 and set out fundamental changes to investment taxation by replacement of fiscal transparency by an opaque tax regime. Furthermore, two regimes for fund taxation have been established – a transparent tax regime (for special funds if they opt for it) and an opaque tax regime (for non-special funds if they do not qualify as a special fund). In contrast to former legislation, the new German Investment Tax Act (ITA) provides for an expansion of the scope of application to cover all UCITS and AIF. However, the new rules only apply to German and international funds treated as corporations. Private equity funds in the legal form of partnerships – that are not UCITS – are not in the scope of the new ITA. General rules on the taxation of partnerships will continue to apply.

Thus, for managers of non-German private equity funds it is necessary to assess, if their legal set-up is comparable to a German partnership or corporation. The tax consequences may differ significantly depending on the result of this classification.

Taxation of private equity funds in the form of partnerships

German private equity funds in the legal form of partnerships and comparable foreign private equity funds are usually subject to the general German tax rules.

The taxation of partnership funds and their investors depends on the classification of the partnership as an asset management or (deemed) business partnership. Under German tax practice (case law), this qualification is based on facts and circumstances rather than on a specific status.

To claim asset management status, the fund vehicle or its general partner partnership should have a managing limited partner, which should be entitled to certain management responsibilities. This concept used to be internationally unique; however, it was recently introduced into Luxembourg partnership law to meet the needs of German individual investors in particular, carried-interest holders, or both. As noted above, BaFin currently seems to struggle with a managing limited partner acting alongside the AIFM. This uncertainty could trigger exits to Luxembourg, assuming the CSSF provides for more flexibility.

In addition, to be qualified as an asset management partnership, the actual investment activities of the fund vehicle have to comply with the catalogue of investment restrictions stated in a specific German tax guidance letter dated 2003. These restrictions used to be significantly stricter than those under the tax concepts of, for example, the United States or the United Kingdom. However, German funds have developed a high level of discipline to deal with the criteria and have often obtained tax rulings to address remaining uncertainties. In August 2011 the highest German federal tax court issued a decision that has caused some confusion as to whether the investment restrictions for a tax-transparent non-trading partnership would be even more restrictive than those in the German tax guidance letter from 2003 have so far been. In the current tax practice, a qualification of private equity funds according to the criteria listed in the tax guidance letter dated 2003 seems to prevail.

The taxation of asset management and business partnerships is different. Whereas an asset management partnership is, for example, basically regarded as tax-transparent, German partnerships that qualify as trading partnerships are subject to German trade tax. Furthermore, German individuals are generally taxed at a rate of 25 per cent (excluding solidarity surcharge) in cases of asset management partnerships, whereas income they receive from business partnerships is subject to their personal income tax rate of up to 45 per cent (excluding solidarity surcharge). However, capital gains from the sale of shares and dividends
are 40 per cent tax-exempt. Corporate investors are principally subject to tax at an amalgamated corporate and trade tax rate of 30 per cent, varying slightly depending on the municipality in which the investor is seated. However, they are entitled to claim a 95 per cent participation exemption on capital gains from the sale of shares for corporate income tax (irrespective of the indirect holding percentage) and trade tax purposes (provided the holding is 15 per cent or higher). In addition, 95 per cent participation exemption can be claimed for dividends provided the indirect holding percentage exceeds 10 per cent.

Life and health insurers and pension schemes, which are not fully exempted from tax, are subject to full taxation on all types of income; however, they are entitled to build against the generally accepted accounting principles (GAAP) profit special reserves for insurance or pension liabilities, which effectively results in an effective tax rate of approximately 2 to 5 per cent. However, for these types of investors it is critical that the income recognition in the GAAP accounts is aligned with allocation of taxable income, as a mismatch could – in a given year – result in an effective tax rate of up to 30 per cent.

International corporate investors have raised concerns about investing in a German limited partnership because if the partnership qualified as a trading partnership, the investors would be subject to German tax-filing requirements and could effectively be taxed in Germany at a rate of approximately 30 per cent (on, for instance, income from interest or from hybrid instruments and dividends from minority shareholdings). These concerns are one reason why a thorough analysis and structuring of a German fund is absolutely necessary; often, a non-German fund might be the better option.

iii Taxation of corporate private equity funds

Corporate investment companies are, for example, closed-ended funds organised as a GmbH, German stock corporations or German investment stock corporations with fixed capital, and foreign entities comparable to these German entities. Commonly used corporate structures, such as the Luxembourg SA, Sarl or SICAV or the UK limited partnership that do not meet the criteria of an investment fund might be classified as corporate investment companies. This may also be true for a French FCPR, Italian fondo chiuso, Luxembourgish FCP or US investment trust.

Private equity funds in the legal form of corporations are within the scope of the revised ITA. Under the new opaque tax regime, corporate private equity funds are taxed as investment funds (mutual and retail funds), and are subject to corporate income tax of 15 per cent plus solidarity surcharge of 5.5 per cent with their German sourced income (i.e., dividends), German rents and gains from the sale of real estate, income from securities lending with German real estate. For German source income that is subject to withholding tax under German tax law, the applicable tax rate is 15 per cent, which will already be applied at source. Moreover, German funds can be subject to trade tax, depending on their structure and commercial activity. All other income, such as capital gains realised upon the sale of shares of German portfolio companies (other than real estate companies) and interest income, is not subject to German tax at the fund level. An exemption, however, does apply, if the objective business purpose is limited to the investment and management of assets.

If certain eligible investors are invested in the fund, an application for tax exemption from corporate tax is possible.

At the level of an investor the income is taxed upon distribution and transfer or redemption of fund units. In addition, investors are taxed on the part of the unrealised added value from non-distributed income accumulated during the year (dry income). No
dry income will occur if the tax-opaque fund does not increase in value during a calendar year, or if the amount distributed to the German investors during a calendar year exceeds the computed dry income. For individuals that hold their investment interest as a private asset, the income is subject to flat tax regime (25 per cent plus surcharges). For investors that hold their investment as a business asset, the income is subject to tax at their personal tax rate. Corporate investors are subject to corporate income tax of 15 per cent (and eventually trade tax) plus solidarity surcharge of 5.5 per cent. The 95 per cent exemption for investment income is not applicable. With respect to investment proceeds from mixed funds, real estate funds and equity funds certain partial exemptions are applicable.

In the event that the German Controlled Foreign Corporation Rules (the CFC Rules) or Passive Foreign Investment Corporation Rules (the PFIC Rules) apply (e.g., if the foreign corporation does not qualified as an investment fund within the meaning of the ITA), they trigger taxation at the level of the German tax-resident investor on ‘passive income’ earned by the foreign corporate investment company, thus breaking down the tax shelter of retained profits. Passive income, in particular, comprises interest income as well as income and realised capital gains from debt instruments; such income will be fully taxable at the level of the investor. To avoid double taxation, dividends received from corporate investment companies and realised capital gains from the sale of shares in such companies are tax-exempt for the German investor to the extent that they were subject to prior CFC or PFIC taxation.

In practice, a participation of German investors in foreign corporate private equity funds will not seem appealing from a tax perspective. To prevent tax discrimination, existing corporate funds as well as new funds may consider setting up in an alternative form (such as a partnership). For Luxembourg vehicles, the newly introduced common limited partnership or special limited partnership may be an option.

iv VAT on management fees and priority profit shares
The management fee of a fund structured as a German limited partnership paid to its general partner or managing limited partner continues to be subject to German VAT at a rate of 19 per cent. The VAT exemption for investment funds under the ITA does not apply.

Until 2007, it was more tax-efficient to structure a priority profit share (PPS) scheme (comparable with the Anglo-American, Guernsey or Jersey structures). The PPS was expressly covered by the relevant tax guidance letter of the Federal Ministry of Finance dated 2003. The scheme provided that the priority profit share had to be sourced from profits calculated under the German commercial balance sheet rules, which, broadly speaking, allow the conversion of commitments into balance sheet reserves that can be dissolved for the benefit of balance sheet profits. However, the Federal Ministry of Finance changed its practice and requested in this context that the fund must be entitled to a repayment of the PPS in the event of a total loss or a lack of commercial profit. In most cases, private equity managers do not accept the offering of a repayment of the PPS to the fund and its investors, because private equity is a risk capital and such managers already share the risk by way of the 1 per cent co-investment that investors request from their managers. Moreover, a profit participation is not possible for externally managed funds, which pay the management fee to an external AIFM that is not an investor in the fund.

Consequently, private equity funds structured as a German limited partnership are subject to VAT on the management fee or the PPS, or both. More complicated structures may reduce the VAT leakage, but this depends on the facts and circumstances of each individual case.
It should be noted that the German government will monitor case law from the European Court of Justice and then examine whether this gives rise to scope for action that can be taken in line with EU law.

v Capitalisation of certain expenses

The German tax authorities take the view that the management fees and other professional expenses arising during the investment period should be capitalised as incidental acquisition costs related to investments in the tax balance sheet of the fund partnership. The same applies with regard to other expenses of the fund that are incurred in connection with the investments. The capitalised expenses would be pro rata allocated to investments acquired during a financial year, and they decrease capital gains upon disposal of the investments.

Because a direct allocation of the fees to individual investments can only be achieved through a complex calculation, the tax authorities have implemented different methods defining how and to what extent these costs are to be allocated to acquired assets and capitalised as incidental acquisition costs and the extent to which they have to be qualified, or requalified, into costs in connection with a disposal of assets and also be deductible first upon divestment of assets. Within a total investment period, the tax authority in Munich, for instance, stipulates the treatment of at least one instance of annual expenditure consisting of management fee, broken deal costs and other professional expenses as a non-deductible incidental acquisition cost of the investments. Additionally, at least one annual expenditure may only be deducted upon disposal of the investments as a divestment cost. The remaining expenditure that occurred during the investment period should be deductible.

On the other hand, the tax authority of Wiesbaden is of the opinion that such expenses have to be capitalised annually during the total investment period proportionately on the basis of the outstanding commitment at the end of the applicable year in relation to the fund’s total commitment.

It should be noted that these practices have not yet been confirmed by any court decision or described in any formal decree of the Federal Ministry of Finance. Moreover, based on experiences from the tax audits, it is questionable whether the tax authorities will maintain their opinion in terms of the capitalisation methodology in future.

vi Carried-interest taxation

Under a specific carried-interest legislation, carried interest is taxed separately from the underlying investment component (e.g., the typical 1 per cent general partner share or co-investment) and qualifies as a service fee (and not as employment income) that is independent from the source of the profits (capital gain, dividend, interest). Under tight restrictions, described below, the service fee could be entitled to a 40 per cent exemption (meaning 60 per cent is taxed at 42 to 45 per cent, with an effective tax rate of up to approximately 28 per cent).

As mentioned earlier, the abolition of the beneficial carried-interest tax regime is being debated. The outcome depends on political discussions; it is currently difficult to predict whether (and when) the beneficial tax regime will be abolished. The 40 per cent exemption is designed for smaller German funds but should also apply in the context of large international buyout funds:

a non-trading fund vehicles – the relevant fund vehicle must qualify as an asset management (non-trading) partnership;
Germany

b full payout – the carried interest will be granted subject to a full payout of capital contributed by the investors. This condition may be difficult to apply on a deal-by-deal carried-interest structure;
c fund promotion – the carried-interest holders have to receive carried interest for their contributions to promote the purpose of the fund;
d private equity – the purpose of the fund is to acquire, hold and dispose of shares in corporations, which should cover private equity funds but may not include hedge funds or distressed funds, etc.;
e carried interest from a trading fund – the carried-interest legislation does not apply to trading funds. Nevertheless, there are strong arguments to apply the 40 per cent exemption to carried interest under the general exemption regime for capital gains and dividends; and
f carried interest from a corporate fund – the German tax administration issued a guidance letter under which dividends paid by a corporate private equity fund are not entitled to the 40 per cent exemption regime. We take the view that this guidance letter is not lawful, since the dividends are entitled to the general 40 per cent participation exemption unless anti-abuse legislation that provides for additional conditions would apply.

V OUTLOOK

Future fundraising for private equity funds in Germany will be dominated by the implementation of BEPS, the AIFMD and the corresponding tax reforms. Under the current provisions, fundraising with a non-German limited partnership should be most advantageous. Non-German funds not structured as limited partnerships but as FCPRs, fondi chiusi, FCPs, trusts or corporations (SICAVs) may suffer disadvantageous tax treatment, unless the tax provisions change significantly. Fundraising with a German limited partnership structure becomes increasingly difficult, even though it would be the most suitable entity to attack the large equity amounts required to finance future renewable energy and infrastructure projects in Germany. The revision of the ordinance for the investment of restricted assets of German insurance companies may have an effect on how funds must be structured to meet investors’ requirements.

Finally, it should be noted that reliable tax planning seems difficult, and German fund taxation remains a field to be closely monitored by private equity fund managers and investors.
Chapter 7

HONG KONG

Lorna Chen, Sean Murphy, Anil Motwani and Iris Wang

I GENERAL OVERVIEW

Hong Kong is a leading international financial centre known for its strategic position as a hub and gateway to mainland China, as well as for being one of the world’s largest capital markets. Hong Kong is also a principal private equity centre, ranking second in Asia after mainland China for total capital under management by private equity funds (excluding real estate funds), which amounted to US$159 billion in 2018. The Hong Kong private equity industry is strengthened by its diversity. Long a preferred destination for global and regional investment fund managers, more than 200 managers were based in Hong Kong in 2018. For these reasons, Hong Kong is likewise an important jurisdiction for leading pension funds, insurance companies, sovereign wealth funds, family offices and other investors.

Asset management and fund advisory businesses in Hong Kong amounted to HK$16,447 billion as at 31 December 2018, resulting in a moderate drop of 6 per cent as compared to 2017. Nonetheless, the private equity industry has continued to see an increase over the past few years in the number of licensed corporations and personnel. From September 2018 to September 2019, the number of corporations licensed in Hong Kong for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities – the three types of licences most relevant to private equity fund managers – grew by 7 per cent, 12 per cent and 10 per cent, respectively. Over the same period, the number of licensed representatives in Hong Kong for Types 1, 4 and 9 regulated activities increased respectively by 2 per cent, 8 per cent and 9 per cent.

The continued growth of the private equity sector in Hong Kong also reflects Hong Kong’s important role in China’s Belt and Road Initiative, one of Chinese President Xi Jinping’s signature initiatives for global infrastructure investment. In addition, the rapid development of the Guangdong–Hong Kong–Macao Greater Bay Area has created an additional need for private investment capital by start-ups in the innovation and technology field.

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Hong Kong is well positioned heading into 2020, thanks in part to tax and legal changes initiated in the past few years by the Hong Kong authorities, including an expansion of the current profit tax exemptions, to encourage the use of vehicles formed locally in Hong Kong; amendments to certain codes of conduct regulating fund managers, to strengthen investor confidence in the Hong Kong private funds market; and tightened regulation over funds investing in virtual assets, to support and promote responsible innovation.

In addition, during 2019, a task force was formed to engage in research and discussions over a proposal for a new limited partnership regime in Hong Kong designed specifically for investment funds. If enacted as expected in 2020, the new regime would replace the existing, century-old statute and attract greater fund formation activity in Hong Kong, thereby strengthening Hong Kong’s position as a jurisdiction of choice for fund managers.

II LEGAL FRAMEWORK FOR FUNDRAISING

The Hong Kong Securities and Futures Commission (SFC) is the principal regulator of Hong Kong’s securities and futures markets, including with respect to private equity fundraising. As empowered by Hong Kong’s primary securities legislation, the Securities and Futures Ordinance (Cap 571) (SFO), the SFC performs a number of key functions central to the private equity industry, including licensing and supervising private equity managers and advisers, and setting and enforcing key regulations covering private equity fund management and the marketing of private equity fund interests in Hong Kong.

i Private placement of private equity fund interests in Hong Kong

Offerings in Hong Kong of interests in private equity funds structured as partnerships or trusts are subject to regulation under the SFO. Offerings in Hong Kong of shares or debentures issued by private investment funds structured as companies are subject to regulation both under the SFO and the Companies Ordinance.

Offering documents relating to securities offered to members of the Hong Kong public, whether offered by a licensed person or not, must be authorised by the SFC unless an exemption applies.

One of the most commonly used exemptions applies to offers made solely to ‘professional investors’ within the meaning of the SFO and its relevant subsidiary legislation. Professional investors broadly encompasses financial institutions, insurance companies, investment companies, retirement schemes, pension plans, government entities and certain high-net-worth individuals and large entities. If fund interests are marketed in Hong Kong, the relevant investors should be provided with a supplemental Hong Kong investor questionnaire to confirm and document their professional investor status. The admission by a fund of certain types of professional investor, including individuals, may cause such fund to be subject to enhanced compliance and due diligence requirements.

To the extent all Hong Kong offerees cannot meet the professional investor standard, another exemption is available under current market practices for offerings to not more than 50 offerees in Hong Kong. Although the offering documents for the types of private offers listed above are not required to comply with prospectus content requirements, they should include an appropriate securities legend to highlight that the offering documents have not been reviewed by any regulatory authority in Hong Kong and that investors are encouraged to seek independent professional advice.

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The common structures for private equity funds with a managerial presence in Hong Kong are (1) fund entities formed as limited partnerships; (2) general partners formed either as limited partnerships or companies; and (3) investment managers or advisers established as companies, typically under the laws of a tax-neutral, offshore jurisdiction such as the Cayman Islands. Typically, a Cayman Islands-domiciled private equity fund with a team of investment professionals based in and working out of Hong Kong would also include a Hong Kong investment manager or adviser entity that employs these professionals and provides investment advice and operational support in respect of the investments that the fund proposes to make. Activities of an investment manager or adviser could, depending on the facts and circumstances, come within various categories of regulated activities under the SFO, including but not limited to selling fund interests to residents in Hong Kong; conducting selling activities in Hong Kong; deal sourcing and execution of transactions; making recommendations and advising with respect to potential deals; and making investment decisions for the investment fund under management. As a result, any such Hong Kong investment manager or adviser entity would likely be required to obtain certain licences from the SFC. The offering of fund interests to investors in Hong Kong must be conducted by an appropriately licensed entity unless marketing takes place entirely outside Hong Kong.

ii SFC licensing regime

General requirements

Any company (or branch office of a foreign company) that carries on a business in a regulated activity in Hong Kong or holds itself out as carrying on a business in a regulated activity in Hong Kong is required to be licensed by the SFC, unless a specific exemption is available.

The SFO prohibits:

a. a person from carrying out a business in a regulated activity or holding himself or herself out as carrying on a business in a regulated activity without a licence; and

b. ‘active marketing’ of any services by any person (including those operating from offshore) to the public, directly or by another person on the person's behalf, if that would constitute a regulated activity if undertaken in Hong Kong, unless the person has obtained a licence.

The SFC guidance suggests that the following factors would be considered in reaching the conclusion that this ‘active marketing’ threshold has been crossed:

a. there is a detailed marketing plan to promote the services;

b. the services are extensively advertised via marketing means such as direct mailing, advertisements in local newspapers, or broadcasting or other ‘push’ technology over the internet (as opposed to where the services are passively available (e.g., on a take-it-or-leave-it basis));

c. the related marketing is conducted in a concerted manner and executed in accordance with a plan or a schedule that indicates a continuing service rather than a one-off exercise;

d. the services are packaged to target the public of Hong Kong (e.g., written in Chinese and denominated in Hong Kong dollars); and

e. the services are sought out by the customers on their own initiative.  

Regulated activity and relevant exemptions

The SFO stipulates 10 types of regulated activity, the most relevant of which for a private equity fund sponsor are Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management).

Type 1 (dealing in securities) regulated activity includes the making or offering to make an agreement with another person or inducing or attempting to induce another person to enter into an agreement for or with the view to acquiring or disposing of securities. If a company engages in the distribution and sale of securities, such as limited partnership interests or shares in a company, a Type 1 licence would thus be required. In addition, if a company engages in deal sourcing and the execution of private equity transactions, including negotiations with a target company, then this conduct may also constitute Type 1 regulated activity.

Type 4 (advising on securities) regulated activity includes the giving of advice on whether to acquire or dispose of securities. If a company provides investment advice for which remuneration is received, then, unless such advisory activities are wholly incidental to Type 1 regulated activity, the company will need to apply for and obtain a Type 4 licence.

Type 9 (asset management) regulated activity includes the managing of a real estate investment scheme or securities or futures contracts. If a company provides portfolio management services and exercises discretionary investment authority to make investment decisions for its clients, then the company will require a Type 9 licence.

As the profile of each private fund management team or sponsor with a managerial presence in Hong Kong may differ depending on such factors as strategy, personnel, business capabilities and operational models, many firms decide to apply for one or a combination of Type 1, 4 or 9 licences, while some other firms instead seek to rely on an exemption from the licensing requirements. Alternatively, some firms may choose to acquire a corporation that is already licensed and, through the acquisition, conduct the desired type of regulated activity. The SFO sets out various exemptions from the licensing requirements, the most relevant of which are profiled below.

Incidental exemption

A company may not need a licence for certain regulated activities if these activities are performed in a manner that is wholly incidental to the carrying out of another regulated activity for which the company is already licensed. For example, if a company holds a Type 9 licence, then that company may rely on the incidental exemption to carry out related Type 1 and Type 4 regulated activities, provided that the preceding activities are undertaken solely for the purposes of the company’s asset management business.

Group company exemption

A company may not need a licence for Type 4 or Type 9 regulated activity if the company provides the relevant advice or services solely to the company's wholly owned subsidiaries, to the company's holding company, which holds all of the company's issued shares, or to other wholly owned subsidiaries of the company’s holding company.

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7 See SFC Licensing Handbook (February 2019) §1.3.3, §1.3.6.
8 See SFC Licensing Handbook (February 2019) §1.3.13.
**Licensing criteria**

**Licence for the corporation**

The core principle behind the Hong Kong licensing regime is that applicants must demonstrate, to the satisfaction of the SFC, fitness and propriety\(^9\) to be licensed. Being fit and proper involves, broadly, being financially sound, competent, honest, reputable and reliable.\(^{10}\)

Certain attributes that a corporate applicant would generally have to satisfy to obtain an SFC licence are set out below.

**Incorporation**

The applicant must be either a company incorporated in Hong Kong or an overseas company registered with the Companies Registry of Hong Kong.

**Competence**

The applicant must prepare and submit several documents, including a shareholding chart, an organisational chart and operation flowcharts. The SFC revamped its licensing process in 2019 by introducing new licensing forms and mandatory electronic submission of annual returns and notifications. Key changes include introducing questionnaires regarding business profile and internal control summaries and requirements to include continuous professional training compliance confirmations in the annual return forms.

**Responsible officers**

The applicant must appoint at least two responsible officers (ROs) to be tasked with direct supervision of the conduct of each proposed regulated activity, with at least one RO being available at all times to supervise each of the proposed regulated activities\(^{12}\) and at least one RO being designated as an executive director.\(^{13}\)

In addition to ROs, any individual who carries on a regulated activity on behalf of the corporation will similarly be required to obtain a licence as a representative accredited to the corporation. Licensed representatives (LRs) may be accredited to more than one licensed corporation. As with ROs, LR applicants must satisfy the SFC that the LR has fulfilled the fit-and-proper requirement. All LR applicants must pass the competence test for a licensed representative.

In addition, all executive directors of the applicant must become ROs accredited to that applicant, and must seek and obtain the SFC’s prior approval to do so.

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9 Authorised financial institutions, such as banks, are required to be registered instead of licensed. This chapter is focused on issues relating to fully licensed corporations.

10 See SFO §129.

11 See SFC Licensing Handbook (February 2019), Fit and Proper Guidelines (October 2013), Guidelines on Competence (March 2003) and Guidelines on Continuous Professional Training (March 2003), issued by the SFC.

12 The same individual may be appointed to be an RO for more than one regulated activity, provided that this individual is fit and proper to be so appointed and there is no conflict in the roles assumed.

13 ‘Executive director’ means a director of the corporation who (1) actively participates in or (2) is responsible for directly supervising, the business of a regulated activity for which the corporation is licensed.
Among other requirements, each RO applicant has to satisfy the SFC that the applicant has fulfilled the fit-and-proper requirements and has sufficient authority to supervise the business of regulated activity within the licensed corporation to which the RO applicant will be accredited.

**Senior management**
The senior management of the applicant must remain primarily responsible for ensuring the company’s maintenance of appropriate standards of conduct and the company’s adherence to procedures that facilitate compliance with those standards of conduct.

**Substantial shareholders, officers and other related persons to be fit and proper**
The applicant must ensure that all substantial shareholders, officers and any other person who is or is to be employed by, or associated with, the corporate applicant for the purposes of the regulated activity for which the application is made shall, likewise, be fit and proper.

**Financial resources**
The applicant must at all times maintain specified amounts of paid-up share capital and liquid capital in accordance with SFO requirements that depend on the licence type.

**Insurance**
If the applicant is a stock exchange participant seeking a Type 1 licence, the applicant must specify to the SFC that the applicant will take out and maintain insurance policies protecting against specific risks for specified amounts based on the SFC’s approval of a master insurance policy applicable to the applicant.

**Ongoing obligations**
Licensed corporations, ROs and LRs must remain fit and proper at all times and comply with both the SFO and any other codes and guidelines issued by the SFC. Key ongoing obligations include:

- display of licence or certificate of registration;
- availability of ROs;
- notification requirements;
- submission of audited accounts;
- payment of certain annual fees; and
- continuous professional training.

14 ‘Substantial shareholder’ means a person who, either alone or with his or her associates, (1) has an interest in shares of the corporation with a nominal value of 10 per cent or more of the issued share capital or that entitles the person to exercise more than 10 per cent of the voting power at general meetings of the corporation, or (2) holds shares in any other corporation that entitles him or her to exercise 35 per cent or more of the voting power at the general meetings of the other corporation, or of a further corporation that is itself entitled to exercise more than 10 per cent of the voting power at the general meeting of the corporation.

15 ‘Officer’ means a member of the senior management (including directors, ROs and ‘managers-in-charge of core functions’), manager or secretary, or any other person involved in the management of the corporation.
iii Codes of conduct
In addition to the SFO, the SFC has issued other codes and guidelines that regulate licensed or registered persons, including the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the Code) and the Fund Manager Code of Conduct (FMCC).

The Code applies to all licensed or registered persons in the course of their performance of the regulated activities for which they are licensed or registered. The Code sets out in detail certain fit-and-proper requirements that such persons must uphold to remain registered, including showing honesty and fairness, conducting and enabling due diligence, making proper disclosures and proper handling of conflicts of interest and client assets. Failure to comply with the Code would not directly and necessarily cause the relevant persons to become subject to legal action. However, the SFC will consider whether any such non-compliance would adversely affect the persons’ status as being fit and proper to remain licensed or registered and, if so, may initiate an investigation using authority granted under the SFO.

The FMCC sets out further conduct and disclosure requirements for persons licensed by or registered with the SFC whose business involves the management of (1) authorised collective investment schemes, (2) unauthorised collective investment schemes, or (3) discretionary accounts. The FMCC, in this manner, supplements other codes and guidelines applicable to licensed or registered persons, including the Code, and emphasises and elaborates on certain existing requirements. Similarly to a breach of the Code, a breach of the FMCC would reflect negatively on a person’s status as being fit and proper, and may create a basis for disciplinary action.

iv Taxation
Sponsors in Hong Kong prefer to set up private funds in certain offshore jurisdictions to enjoy tax neutrality or the otherwise preferential tax rates and treaty benefits that these jurisdictions may offer. Funds that are domiciled outside of Hong Kong may be exempted from the Hong Kong profits tax if certain conditions under the Inland Revenue Ordinance (Cap 112) are met. The profit tax implications may vary for the asset-based management fees and variable performance fees that are often payable to fund managers.

Although a Hong Kong-based investment manager or adviser may advise on the operation of the fund, a portion of profits and income may remain with a separate Cayman-based fund manager or adviser, pursuant to appropriate commercial arrangements. In recent years, taxation of fund managers and advisers in Hong Kong has drawn closer scrutiny by the Inland Revenue Department (IRD) in terms of both the nature and source of income derived and also the sufficiency of amounts received by the Hong Kong-based investment manager or adviser.

In the current market, sponsors of private equity funds would be advised to carefully review the service agreements among managerial entities, alongside the underlying compensation arrangements, to anticipate and defend against any challenges from the IRD.

III REGULATORY DEVELOPMENTS

i Hong Kong limited partnership regime
During 2019, a task force was formed to develop a proposal for a modern limited partnership regime in Hong Kong. Benefiting from research into Hong Kong’s market landscape as well as international trends, the proposal should be better suited to the current needs and desires
of market participants in Hong Kong’s private equity fund industry than the existing regime, which was last amended in 1924. If the updated regime is enacted in 2020, as projected, then funds in the Cayman Islands or elsewhere being operationally managed from Hong Kong may re-domicile to Hong Kong (and, correspondingly, successor vintages of such funds may be formed in Hong Kong), thereby aligning legal structures with business activities, and contributing to Hong Kong’s ongoing growth as a global financial centre.

ii  Regulatory approach for cryptocurrency assets and complex products

In light of the growing investor interest in virtual assets (including exposure to such assets through private equity funds) and the growth in unlicensed trading platform operators in Hong Kong, the SFC, on 1 November 2018, announced a new regulatory framework for the governance of virtual assets.16 Among other things, the SFC announced that terms and conditions will be imposed on licensed corporations that manage or plan to manage portfolios with a stated investment objective to invest in virtual assets or an intention to invest 10 per cent or more of the gross asset value of the portfolio in virtual assets (collectively, virtual asset fund managers).

On 4 October 2019, the SFC published the proforma ‘Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets’,17 which further sets out the terms and conditions that will be imposed on all virtual asset fund managers, subject to minor variations and elaborations depending on the individual virtual asset fund manager’s business model and circumstances. These terms and conditions are mostly principle-based and will be imposed on virtual asset fund managers by way of a licensing condition. Failure to observe such licensing condition may be considered as misconduct under the SFO and may adversely affect the fitness and properness of a virtual asset fund manager and even result in disciplinary action by the SFC.

The SFC issued a circular on 13 June 2019 on the implementation of regulatory requirements for the online and offline sale of complex products. A complex product is ‘an investment product whose terms, features and risks are not reasonably likely to be understood by a retail investor because of its complex structure’. Factors to determine whether an investment product is complex or not are further set out in the Guidelines on Online Distribution and Advisory Platforms and the Code, and include, but are not limited to:

1. whether a secondary market is available for the investment product at publicly available prices;
2. whether there is adequate and transparent information about the investment product available to retail investors; and
3. whether any features or terms of the investment product might render the investment illiquid or difficult to value.18

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18 See Guidelines on Online Distribution and Advisory Platforms, Section 6.1.
Thus, a private fund is likely to be considered a complex product that is subject to enhanced requirements relating to suitability, the provision of information and warning statements.

iii SFC licensing guidance for private equity firms and family offices

On 7 January 2020, the SFC issued guidance on the licensing obligations of private equity firms and family offices that conduct business in Hong Kong. In a circular to private equity firms seeking to be licensed,19 the SFC clarifies certain existing licensing requirements, such as those applicable to general partners and investment committee members offering co-investment opportunities and fund marketing activities. The circular also clarifies how the SFC assesses private equity firms’ discretionary investment authority and investments in securities of private companies, as well as the industry experience requirement for their responsible officers. A separate circular20 provides general guidance for family offices intending to carry out asset management or other services in Hong Kong and explains the potential implications for both single and multi-family offices. Licensing exemptions, or carve-outs, may be available depending on how a family office operates.

IV OUTLOOK

Hong Kong, as Asia’s leading financial centre and a major gateway to China, has attracted the interest of both domestic and international investors. The private equity industry in Hong Kong has experienced tremendous growth in the past decade. Faced with a growing number of participants and capital under management, on the one hand, and transforming technology and evolving global financial conditions on the other hand, Hong Kong is widely expected to develop and tighten regulations aimed at mitigating financial risks and keeping pace with regulatory developments in comparable international markets.

Recent years have seen the SFC increasing its efforts to fight irregularities in the private equity market and strengthen its scrutiny over fund managers on various aspects of their businesses, including the licensing requirement and approval process, the role of transfer pricing in a firm’s managerial structure and the appropriate regulatory approach to investments in new industries. While Hong Kong is expected to maintain its historically competitive edge in terms of free trade, low tax and freedom of capital mobility, it will likewise continue to closely monitor and regulate the conduct of the private equity industry in a way that embraces and benefits from China’s economic boom, the new global economy and growing financial integration.

GENERAL OVERVIEW

After a remarkable overall surge in 2018, the private equity (PE) landscape in India witnessed a mixed bag of trends and challenges in 2019. While the value of PE deals skyrocketed, the number of deals showed a downward trend, fundraising activity was rather subdued and exits declined sharply in terms of volume and value.

2018 had ended on a high note, leaving room for hope on account of the impending general elections. However, 2019 proved to be a slow year for the Indian economy. After the general election results in May, the economy recorded a decline in growth to 5 per cent for the second quarter of 2019 against the impressive 8 per cent in the same period in 2018. The third quarter witnessed further decline in economic growth to a six-year low of 4.5 per cent. At the same time, India jumped 14 places to the 63rd position out of 190 countries in the World Bank’s annual global Ease of Doing Business rankings, a ‘tremendous achievement, especially for an economy that is as large and complex as India’.

Despite this slowdown, certain trends from 2018 continued in 2019. For instance, global PE and M&A investors continued to gravitate towards India and investment values continued to surge. The interest shown by global pension funds and sovereign wealth funds (SWFs) in India continued on an upward trajectory, with SWFs from Abu Dhabi, Canada and Singapore having made some of the largest PE investments. Investors’ focus remained fixed on control and governance. As a result, consolidation and deleveraging continued to be the key drivers and buyouts increased drastically, surpassing the total value of buyouts by 30 per cent compared to that in 2018. In terms of sectors, the technology sector continued to attract investors and there was an increased interest in the infrastructure sector. Due to the introduction of the amended Insolvency and Bankruptcy Code and the continuing crisis relating to non-banking financial companies, the Indian stressed assets market continued to present a host of opportunities for PE investors.

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1 Raghubir Menon and Ekta Gupta are partners, Deepa Rekha is a principal associate, Srishti Maheshwari is a senior associate and Rooha Khurshid is an associate at Shardul Amarchand Mangaldas & Co.
2019 also witnessed certain unique trends. The launch of India’s first real estate investment trust (REIT), Embassy Office Parks REIT, by Blackstone and the Embassy Group not only offers hope for the liquidity crunch-ridden real estate sector but is also expected to be a game changer and pave the way for more investment vehicles of a similar nature. Platform deals are gaining momentum across multiple sectors owing to buyouts reaching an all-time high primarily due to private equity investments, and investors are increasingly tending towards a more concise and focused investment approach; therefore, adopting a buy-and-build approach. Domestic financial services groups such as Kotak and Edelweiss raised substantial amounts of capital for their specialised distressed asset arms with the aim of investing in companies that are already bankrupt or on the brink of bankruptcy. It is likely that debt will drive opportunities in 2020. Lastly, late-stage start-ups garnered attention from SWFs, which provided growth funding to e-commerce start-ups in various sectors such as logistics and pharmaceuticals. This is indicative of SWFs’ growing interest in India as well as their growing risk appetite.

**2019 v. 2018**

2019 started on a high note with fundraisings worth US$2.5 billion recorded in January, the highest monthly fundraising ever. The first quarter of 2019 recorded a total fundraising of US$2.8 billion, which was more than twice the value of funds raised in the same period of 2018. In fact, the first half of 2019, with total fundraising of US$5.5 billion, witnessed an 85 per cent increase in fundraising compared to that in the first half of 2018. However, the third quarter of 2019 recorded fundraisings worth US$2.3 billion, an 11.5 per cent decline compared to the amount of fundraising recorded in the third quarter of 2018. Even though the aggregate of funds raised in November 2019 (US$172 million) declined by nearly 50 per cent in comparison to November 2018 (US$398 million), large India-dedicated fundraising plans worth US$2.3 billion were announced, which continued to inspire hope for the Indian PE landscape among investors.

Unlike 2018, which recorded the highest-ever annual fundraising total of US$8.1 billion, 2019 witnessed PE firms struggling to hit the final fundraising milestone, with only five Indian funds hitting the final close in 2019. The sector-agnostic True North and Multiples, which have been trying to reach final close for nearly two years, are yet to achieve their target. This sluggishness in PE fundraising is in stark contrast to the trend in the venture capital (VC) sector where global and domestic limited partners (LPs) pumped a substantial amount of money into India-focused VC funds in 2019.

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5 An investment vehicle that owns and operates real estate-related assets and allows individual investors to earn income produced through ownership of commercial real estate without actually having to buy any assets.
7 See footnote 4.
8 ibid.
9 See footnote 3.
Some of the significant fundraisings in 2019 were in the structured credit and debt sector. The private credit fund Edelweiss Alternative Asset Advisors Ltd (through Edelweiss India Special Asset Fund II (EISAF II)) has raised US$1.3 billion for investments in non-performing assets (NPAs), making it the largest fundraising in the private-debt strategy space in India.\textsuperscript{16} Edelweiss Global Wealth and Asset Management looks to raise nearly US$1 billion through its third fund, Edelweiss Special Opportunities Fund III, for investments in growth-seeking holding and operating firms.\textsuperscript{17} India Resurgence Fund is eyeing a final close of its first India-focused fund at US$750 million for investment in distressed assets in India\textsuperscript{18} and has received a commitment of US$225 million from Canada Pension Plan Investment Board (CPPIB).\textsuperscript{19} Kotak Special Situations Fund, a sector-agnostic fund launched in February 2019, has reached a total commitment of US$1 billion (with a commitment of US$500 million from the Abu Dhabi Investment Authority) for tapping distressed debt opportunities in India.\textsuperscript{20} Another significant fundraising in 2019 was the US$850 million fund raised by the India-focused private equity fund, ChrysCapital. This fundraising is ChrysCapital’s eighth fund, was the fastest ever fund raise and made ChrysCapital the largest India-focused private equity investor.\textsuperscript{21}

Significant fundraising announcements include the platform created by the National Investment and Infrastructure Fund (NIIF) and CPPIB’s highway operator Roadis for investment (in equal proportions) up to US$2 billion in toll-operate-transfer models, acquisition of existing road concessions and other investment opportunities.\textsuperscript{22} Warburg Pincus LLC plans to raise up to US$1.5 billion pursuant to its plans to launch its first India-focused private equity fund for investments in the financial, manufacturing and consumer sectors.\textsuperscript{23} The Department for Promotion of Industry and Internal Trade (DPIIT) has prepared a vision document, \textit{Startup India Vision 2024}, for facilitating the setting up of the following, in India, by 2024:
\begin{itemize}
  \item[a] 50,000 new start-ups;
  \item[b] 500 incubators and accelerators;
  \item[c] 100 innovation zones in urban local bodies;
  \item[d] deployment of the entire 100 billion rupee corpus of the Fund of Funds;
  \item[e] expansion of corporate social responsibility funding to incubators;
  \item[f] an ‘India start-up fund’ worth 10 billion rupees;
  \item[g] 10 billion rupees of seed funding; and
  \item[h] seven research parks.
\end{itemize}

\textsuperscript{16} www.vccircle.com/edelweiss-private-credit-fund-raises-1-3-bn-for-investment-in-stressed-assets/.
\textsuperscript{17} www.livemint.com/companies/news/edelweiss-eyes-1-billion-corpus-for-latest-fund-1553542141658.html.
\textsuperscript{20} www.livemint.com/industry/banking/kotak-special-situations-fund-gets-commitments-worth-1-billion-1565602811437.html.
\textsuperscript{22} https://niifindia.in/national-investment-and-infrastructure-fund/.
In addition, the vision document contemplates tax incentives for investments in start-ups, exemption of angel tax on all investments by alternate investment funds (AIFs) and setting up a regulatory sandbox for testing innovative financial products. This government initiative is expected to strengthen the start-up ecosystem in India.\(^{24}\) Temasek Holdings Pte and EQT Infrastructure IV have set up O2 Power, a US$500 million renewable energy platform, in India, which aims to achieve more than four gigawatts of installed capacity in solar and wind projects, through mergers and acquisitions. This would be EQT Infrastructure IV’s first investment in India with an approximate 65 per cent contribution in the platform.\(^{25}\) Global Infrastructure Partners, through its Indian business unit, Vector Green Energy, is set to acquire the 300-megawatt solar generation capacity of Rattan India for an estimated value of US$10 billion.\(^{26}\)

ii Industry sector trends

In continuation of the trends in 2018, sector-agnostic funds did not dominate fundraising activity in 2019, and the real estate, consumer technology and financial services sectors continued to witness a substantial amount of fundraising activity. In the real estate sector in particular, commercial real estate saw an increase in investments, while the residential segment struggled.\(^{27}\) The infrastructure sector dominated the fundraising landscape and reinforced the increasing investor interest in investment platforms. The highlight of 2019 was India’s first ever REIT, raised by Embassy Office Parks, a Bangalore-based real estate developer, and backed by Blackstone Group LP.\(^{28}\)

iii Infrastructure

The NIIF and Roadis (a highway concessions company) announced a platform that will invest up to US$2 billion in highway projects in India to create a large roads platform by targeting toll-operate-transfer models and acquiring existing road concessions and investment opportunities in the roads sector.\(^{29}\) The New York-based Global Infrastructure Partners has initiated a soft launch of its India-focused infrastructure fund that has a target corpus of US$1 billion and will focus on the acquisition of operating assets in areas such as roads, renewables and transmission.\(^{30}\) CPPIB has committed US$600 million to the NIIF by committing US$150 million to the NIIF Master Fund and agreeing to co-investment rights of up to US$450 million in future opportunities to invest alongside the NIIF Master Fund. As a result of CPPIB’s investment, the NIIF Master Fund has reached US$2.1 billion.

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in commitments and has achieved its initial targeted fund size. The Piramal Group and Lone Star Funds are in the process of setting up an investment platform of a US$600 million to US$700 million fund for the purpose of acquiring operating road assets. In addition, APG Asset Management and Piramal Enterprises are looking to raise a second fund of US$500 million to invest in infrastructure projects in India.

iv Stressed assets, NPAs and structured debt
The most significant fundraising in 2019 was EISAF II, a US$1.3 billion fund set up by Edelweiss Financial Services for the purpose of investment in distressed assets. Edelweiss Financial Services also announced its intention to raise US$1 billion in funds for its third AIF, Edelweiss Special Opportunities Fund III, which will focus on structured credit and investments in the performing credit space. Similarly, AION Capital Ltd has started raising funds for its second fund, which has a targeted corpus of US$1 billion for investment in structured credit.

The US$1 billion Kotak Special Situations Fund, Lone Star’s announced US$1 billion fund and CPPIB’s commitment of US$225 million to the India Resurgence Fund are some of the other significant PE fund raisings in the Indian debt market. Taking note of the impact of the liquidity crisis on small and medium-sized enterprises (MSMEs), a Reserve Bank of India (RBI) panel has recommended the creation of a government-sponsored distressed assets fund of US$719 million to support crowdfunding from VC and PE firms focused on investment in MSMEs.

v Consumer, technology and financial services
A91 Partners closed one of the largest consumer-focused funds at US$350 million for the purpose of investment across consumer, healthcare, financial services and technology companies. Lighthouse Funds closed its third consumer-focused fund at US$230 million, which aims to assist companies with operational enhancement, marketing and sales

35 www.vccircle.com/edelweiss-targets-1-bn-corpus-for-structured-credit-fund/.
36 www.livemint.com/Companies/sbNBhD1cXeoovKWO0hvEncL/AION-Cap-targets-1-billion-corpus-for-new-fund.html.
37 See footnote 20.
optimisation, mergers and acquisitions and human capital enhancement. Investcorp raised a US$142 million fund for the purpose of investment in the consumer, financial services and healthcare sectors. IIFL Asset Management Co Ltd raised US$134 million for its first PE fund, which will focus on the financial, consumer, healthcare and technology sectors with the aim of backing professional entrepreneurs and investing across the multiple life stages of a business. DSG Consumer Partners raised a US$65 million fund for the purpose of early stage investment in the consumer sector.

**vi Early stage**

Nexus Venture Partners raised a US$350 million fund focused on the consumer-retail sector. Lightbox Ventures closed its third India-focused fund at US$209 million, taking the total capital raised by the firm to over US$400 million. The other significant fundraisings in the early stage sector include the US$60 million raised by Fireside Ventures for its second fund, which has a target corpus of US$100 million; DSG Consumer Partners’ third fund, which closed at US$65 million and will be focusing on investing in seed and Series A rounds; and the US$50 million fund raised by Tanglin Venture Partners for investing in technology start-ups in India and South East Asia. Binny Bansal (the former CEO of India’s e-commerce major, Flipkart) has announced his plans to launch a US$400 million fund to invest in start-ups in India that are in need of growth capital.

**vii Real estate**

Xander Investment Management raised a US$250 million fund for investment in industrial real estate in India. Motilal Oswal Real Estate hit the second close of its fourth fund (which has a target corpus of US$211 million) at US$128 million and will use this fund for investment in mid-income and affordable housing projects across the top six Indian cities and in selective commercial projects. SmartOwner announced the launch of a real estate fund with a target corpus of US$70 million, which will focus on investment in real estate such as

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co-working and commercial spaces. Investcorp, which acquired the PE and real estate funds businesses of IDFC Alternatives Ltd in 2019, which marked its entry into the Indian market, announced its maiden India-focused fund of US$300 million.

viii Healthcare

InvAscent raised US$250 million for its third fund, India Life Sciences Fund, for early stage investments in the healthcare and pharmaceutical sectors. A91 Partners’ US$350 million fund, focused on investments across sectors such as healthcare and technology, will be one of the largest maiden domestic funds raised by Indian general partners (GPs). Quadria Capital announced a US$400 million fund for investment in healthcare, life sciences and associated areas.

ix Sector agnostic

The most significant sector-agnostic fundraising was the close of ChrysCapital’s (one of India’s largest home-grown private equity firms) eighth fund at US$850 million. The close of this fund has increased the size of ChrysCapital’s assets under management to US$4 billion. Other significant fundraisings include the US$406 million fund raised by B Capital (Facebook co-founder Eduardo Saverin’s global VC firm) and the US$60 million fund raised by Fireside Ventures.

x Investments and exits

The total value of PE deals at US$38 billion surpassed 2018’s total of US$35.1 billion and hit a new high in 2019. As the total value rose while deal volume fell, the average ticket size for PE deals surged nearly 50 per cent and the number of billion-dollar deals doubled. This is in sharp contrast to the trend in 2018 when the ticket size of the deals remained flat due to a marginal fall in both volume and value. Despite the overwhelming increase in the value of deals, the number of deals declined from 1,362 in 2018 to 1,307 in 2019, presumably

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59 www.livemint.com/Companies/n2gPqbjnVzHMGyo6YTgbl/ChrysCapital-closes-8th-private-equity-fund-at-850-million.html.
61 See footnote 48.
63 ibid.
because the highways and renewable energy sectors are where the Indian market is highly concentrated and other sectors (e.g., aviation, ports and telecoms) have few meaningful assets that hold potential for investments.64

2019 witnessed the largest ever private equity deal in India, in the acquisition of the telecoms tower business of Reliance Infrastructure Limited by Brookfield Asset Management Inc (a Canadian investment firm) for US$3.7 billion.65 In addition, Brookfield, through its infrastructure investment trust, acquired a 1,480-km gas pipeline by acquisition of East West Pipeline Limited (a Reliance group company) for US$1.9 billion.66 Other significant PE investments in 2019 include the US$1.6 billion investment in the airports unit of GMR Infrastructure by a consortium of investors comprising of Tata Group, SSG Capital Management and GIC (a Singapore sovereign wealth fund);67 the US$1.1 billion investment in GVK Airports by the Abu Dhabi Investment Authority, Canada's Public Sector Pension Investment Board and the Indian government-backed NIIF;68 and the US$1 billion investment in India's leading digital payments company, Paytm, by a group of investors led by T Rowe Price (a US-based asset manager) and comprising of existing shareholders of Paytm (Alibaba, Softbank and Discovery Capital).69

In terms of sectors, the infrastructure sector received the most attention from investors. While the number of deals in the real estate sector dropped, other sectors that continued to draw investors include the energy, technology and financial services sectors.70 The hospitality sector witnessed a leap in investor interest on the back of investments worth US$1.2 billion across two deals:71 the US$500 million investment by Brookfield in the debt-ridden Hotel Leela72 and the US$600 million investment by GIC in an Indian Hotels Company special purpose vehicle (SPV).73

2019 witnessed a decline in exits in terms of both value and volume due to the volatility of the market. There were 185 exits with a combined value of approximately US$9.5 billion, which is a 63 per cent decline in terms of value from 2018, which saw 262 exits worth US$25.9 billion, including Walmart’s US$16 billion acquisition of Flipkart from multiple investors.74 The majority of exits were by way of public market deals (up 45 per cent compared with 2018) and initial public offerings (down 67 per cent on 2018), followed by mergers and acquisitions and secondary deals.75

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Two of the most significant exits of 2019 generated substantial return within only a few years of investment.

Warburg Pincus struck two exits in 2019:

\(a\) the sale of its entire stake in ICICI Lombard for approximately US$200 million (which is also the company’s quickest exit in India, resulting in approximately 40 per cent of annualised return within two years of investment);\(^{76}\) and

\(b\) the sale of its 13-year-old investment in the Lemon Tree Hotels Limited hotel chain, for US$40 million, resulting in a sub-par return on its investment.\(^{77}\)

Another exit that demonstrated a quick churn of investment was the buyout of the majority stake in India and South Asia-focused cancer treatment provider, Cancer Treatment Services International, of TPG Growth by New York-listed Varian Medical Systems Inc for US$283 million only three years after making the investment.\(^{78}\) The other significant exits in 2019 include the sale of a minority stake in SBI Life Insurance Company Limited by Carlyle for US$393 million, resulting in a spectacular 120 per cent return on investment;\(^{79}\) and the exit of Sixth Sense from Hindustan Foods Ltd at a value of US$8 million, earning a nine-fold return on its investment in the contract manufacturer for fast-moving consumer goods companies, which is one of the highest ever returns earned by a firm in India.\(^{80}\)

### Reception by LPs and fund managers

According to a market survey conducted by the Emerging Markets Private Equity Association, while India has slid from second to third position in its perceived attractiveness to LPs and GPs, it has continued to hold steady since 2015. LPs’ past concerns in relation to the exit environment and the uncertain political environment seem to have been allayed with recent changes and the conclusion of the general elections in 2019. In fact, of all the emerging markets, India attracts the highest percentage of LPs because of the favourable exit opportunities available to technology-enabled companies, with 63 per cent of all LPs currently investing or planning to invest in technology opportunities in India.\(^{81}\) The fact that most of the significant fundraisings of 2019 were by home-grown funds is a step in a positive direction to resolve the long-standing issue of lack of local participation in funds and fund management. In terms of disadvantages, investors have cited oversupply of funds and high-entry multiples as deterrents to investment in India, while many have already achieved their recommended levels of exposure to the Indian market.\(^{82}\)

While 2019 was an excellent year in terms of PE investment and a year of steady and consistent performance in terms of fundraising and exit activity, the slowdown of the Indian economy, the decline in exports and the rise in international crude oil prices are factors that are likely to impact PE activity in India. However, given that investors hold a long-term perspective towards India, they may remain unfazed by the current market slowdown.

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\(^{82}\) ibid.
With a turbulent and uncertain 2020 ahead, the need of the hour is a more favourable deal environment coupled with effective economic measures and governance reforms that will boost investor sentiments and increase the attractiveness of the Indian market.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Offshore structures
Foreign investors have always opted for a jurisdiction that provided tax neutrality to them with respect to their investments in India. Under the Indian tax regime, a non-resident investor is subject to tax in India if it receives or is deemed to receive income in India; or income accrues or arises or is deemed to accrue or arise in India. However, if the non-resident is based out of a jurisdiction that has entered into a double-taxation avoidance treaty (DTA) with India, the taxation implications are nullified and the Indian income tax laws apply only to the extent they are more beneficial than the tax treaties. Accordingly, most India-focused funds are based out of either Singapore or Mauritius as a limited liability partnership (LLP) or a corporate entity. Further, the GP and the investment manager, who set up and operate the investment vehicle, are located outside India.

ii Tax risks re offshore structures
To curb tax avoidance, the government introduced the General Anti-Avoidance Rule (GAAR), with effect from the financial year beginning on 1 April 2017. The introduction of the GAAR has provided the tax authorities with the ammunition to recharacterise a transaction or an arrangement such that it gets taxed on the basis of substance, rather than on its form. The consequences include investment vehicles being denied DTA benefits or reclassification of capital gains as any other income, or a combination of these. In addition, the government amended the criteria for determining the tax residence of offshore companies by introducing the place-of-effective-management (POEM) guidelines, with effect from 1 April 2017. According to the POEM guidelines, if the key management and commercial decisions that are necessary to conduct the business of any entity as a whole are, in substance, made in India, an offshore entity could be construed as being tax resident in India.

The past two years also witnessed India renegotiating its DTA agreements with Singapore and Mauritius, making these less attractive as fund jurisdictions. The details of these changes along with an analysis on the future of these countries as viable fund jurisdictions is set out in detail in Section II.vi.

iii Rise of unified structures with direct investment by LPs
The fear of tax exposure owing to the various changes set out above has led to investors exploring unified structures or co-investment structures. Under the unified structure, both domestic and foreign investors make their investments into a domestic pooling vehicle. These unified structures received a huge impetus in 2015.

Until 2015, these investment vehicles were heavily funded by domestic investors since prior permission from the Foreign Investment Promotion Board was required if the overseas funds intended to directly invest in a privately pooled vehicle in India. To increase the participation of offshore funds in these investment vehicles, since November 2015, the RBI has permitted such investment vehicles to receive investments from non-resident Indian investors and foreign investors through the automatic route, as long as control of the investment vehicles vests in the hands of sponsors and managers, or investment managers,
that are considered Indian-owned and controlled under the extant foreign regulations; investments by Indian-controlled AIFs with foreign investment are thus deemed to be domestic investments.

iv Legal framework of domestic funds

Alternative investment funds

Prior to private equity capital gaining popularity, entrepreneurs relied heavily on loan capital raised from banks and financial institutions, public issuances and private placements. Realising the potential role of PE funds and the value addition they would contribute to the growth of corporate entities, the Securities and Exchange Board of India (SEBI) introduced a set of regulations governing investments by VC companies. This was followed by an overhaul in the regulations in 2012 with the introduction of the SEBI (Alternative Investment Funds) Regulations 2012 (the AIF Regulations) to regulate privately pooled investment vehicles that collect funds from investors on a private placement basis. The AIF Regulations replace the earlier regulatory framework of the SEBI (Venture Capital Funds) Regulations 1996, which covered funds that primarily invested in unlisted VC undertakings.

Under the AIF Regulations, an AIF is a privately pooled investment vehicle incorporated in the form of an LLP, trust or body corporate, which collects funds from Indian and foreign investors for investments in accordance with a defined investment policy for the benefit of its investors.

Based on the nature of the funds and their investment focus, the AIF Regulations categorise funds into Category I AIF, Category II AIF and Category III AIF. These categories of funds must also comply with distinct investment conditions and restrictions during their life.

The AIF Regulations prescribe, inter alia, a cap of 1,000 on the number of investors pooling into the AIF, conditionality on the minimum corpus for the fund and a minimum amount to be invested by an investor. To align the interests of the investors and the promoters or sponsors of the fund, the sponsor or manager of the AIF is required to have a continuing interest in the AIF throughout the life of the AIF. Further, investment by the sponsor or manager of a Category I AIF or Category II AIF has to be at least 2.5 per cent of the corpus (at any given point) of the AIF or 50 million rupees, whichever is lower. The continuing interest in the case of a Category III AIF has to be at least 5 per cent of the corpus or 100 million rupees, whichever is lower.

Before commencing operations, AIFs should register with SEBI, which takes about four to six weeks. An AIF can be set up in the form of a trust, a company, an LLP or a body corporate. Most funds in India opt for the trust structure. The entities involved in

83 An AIF that invests in start-up or early stage ventures, social ventures, small and medium-sized enterprises, in infrastructure or other sectors or areas that the government or regulators consider socially or economically desirable (including VC funds, SME funds, social venture funds, infrastructure funds, angel funds and such other AIFs as may be specified).

84 An AIF that does not fall into Category I and III and does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted under the AIF Regulations will be a Category II AIF.

85 An AIF that employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives will be a Category III AIF. AIFs such as hedge funds or funds that trade with a view to making short-term returns or other open-ended funds can be included.
the structure are a settlor, a trustee and a contributor. The settlor settles the trust with a small amount as an initial settlement. The trustee is appointed to administer the trust and is paid a fee in lieu of such services. The investor signs up to a contribution agreement or a subscription agreement to make a capital commitment to the fund.

**Sector-focused fund structures**

**REITs and infrastructure investment trusts**

In 2014, SEBI notified the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations 2014 (the REIT Regulations) and the SEBI (Infrastructure Investment Trusts) Regulations 2014 (the Infrastructure Regulations) to regulate investments in the real estate and infrastructure sectors respectively. An infrastructure investment trust (InvIT) and a REIT must register with SEBI to conduct their business.

A REIT is a trust formed under the Indian Trust Act 1882 (the Trust Act) and registered under the Registration Act 1908 with the primary objective of undertaking the business of real estate investment in accordance with the REIT Regulations and has separate persons designated as sponsor, manager and trustee. The REIT is created by the sponsor of the trust, the trustee oversees the entire REIT and ensures all rules are complied with, and the beneficiaries are the unitholders of the REIT. The parties involved in the establishment of the REIT are: (1) the sponsor; (2) the trustee; (3) the investment manager and (4) the valuer. Each REIT is allowed to have a maximum of three sponsors, with each of these having a net worth of not less than 200 million rupees and a collective net worth of not less than 1 billion rupees. The sponsor should have not less than five years’ experience in the development of the real estate sector. The trustee is the owner of the REIT assets, which it holds for the benefit of the unitholders, and it oversees the activities of the manager. The investment manager enters into an investment management agreement with the trustee and makes the investment decisions for the REIT. The responsibility of the valuer is to conduct half-yearly and annual valuations of the REIT’s assets. The REIT Regulations impose a restriction on a REIT to invest only in SPVs or properties or transfer development rights in India or mortgage-backed securities. A REIT is allowed to make an initial offer of its units only through a public issue. No such offer can be made unless the offer size is at least 2.5 billion rupees and the value of the assets is not less than 5 billion rupees.

Akin to a REIT, an InvIT is a trust formed under the Trust Act and registered under the Registration Act. The InvIT is created by the sponsor of the trust, the ownership of the property vests in the trustee and the beneficiaries are the unitholders of the InvIT. It should be ensured that no unitholder of an InvIT enjoys superior voting rights or any other rights over another unitholder. Further, the Infrastructure Regulations prohibit multiple classes of units of InvITs. The Infrastructure Regulations require that an InvIT must hold not less than 51 per cent of the equity share capital or interest in the project SPVs. The parties involved in the establishment of the InvIT are: (1) the sponsor, (2) the trustee, (3) the investment manager, and (4) the project manager. The sponsor is responsible for the creation of the trust. The trustee is the owner of the InvIT assets, which it holds for the benefit of the unitholders. While the investment manager makes the investment decisions for the InvIT, the project manager is responsible for achieving the execution or management of the project in accordance with the Infrastructure Regulations. The Infrastructure Regulations further require that the investment manager, in consultation with the trustee, is required to appoint the majority of the board of directors or governing board of the holding company and SPVs.
India

Both the Infrastructure Regulations and the REIT Regulations include conditions on investment and borrowing powers, the process for listing and trading of units, net worth and experience requirements, rights and obligations of different entities involved and the valuation of assets and the distribution policy. The distinguishing feature is that the Infrastructure Regulations exclude projects that generate revenue or profit from rental or leasehold income.

In 2017, the RBI permitted banks to participate in REITs and InvITs within the overall ceiling of 20 per cent of their net owned funds for direct investments in shares, convertible bonds or debentures, units of equity-oriented mutual funds and exposure to venture capital funds (VCFs) both registered and unregistered, subject to the following conditions: (1) the banks must have put in place a board-approved policy on exposure to REITs or InvITs specifying the internal limit on such investments within the overall exposure limits in respect of the real estate sector and infrastructure sector; (2) not more than 10 per cent of the unit capital of a REIT or InvIT can be invested by the banks; and (3) the banks must adhere to the prudential guidelines of the RBI, as applicable. In October 2019, the RBI further permitted banks to lend funds and extend credit facilities to InvITs subject to certain conditions, including: (1) the banks must have adopted a board-approved policy on exposures to InvITs specifying, inter alia, the appraisal mechanism, sanctioning conditions, internal limits and monitoring mechanism; (2) the banks can only lend to such InvITs where none of the underlying SPVs, having existing bank loans, is facing a ‘financial difficulty’; (3) bank finance to InvITs for acquiring equity in other entities will be subject to the RBI guidelines, as applicable; and (4) the banks must undertake an assessment of all critical parameters to ensure timely debt servicing. Such availability of credit to InvITs is a welcome move as it will encourage investments into and by InvITs.

In November 2018, SEBI amended the guidelines for public issues of REIT and InvIT units with a view to further rationalising and easing the issue process. 2019 witnessed further amendments to the REIT Regulations and Infrastructure Regulations, details of which are set out in Section VII.iii.

At present, there are two public InvITs, three privately placed InvITs and one listed REIT. According to SEBI, investors infused 6.7 billion rupees in REITs and 113.47 billion rupees in InvITs aggregating to 120 billion rupees in 2019. In particular, mutual funds increased their investment in REITs by 10 times from 70 million rupees in January 2019 to 725 million rupees in December 2019. While InvITs are expected to benefit from the RBI’s decision to allow banks to lend them funds, REITs offer a potential avenue for investors due to declining interest of investors in the residential segment for limited appreciation in property prices and inability to monetise assets.

Steps to popularise domestic funds as fund structures

Over the past year, the government has taken steps for mobilising domestic capital from banks, mutual funds and insurance companies. In fact, the Alternative Investment Policy Advisory Committee in its report submitted on 19 January 2018 recommended the use of domestic funds as they currently constitute only a minor percentage of the total funds invested annually. Under a domestic fund structure, the fund vehicle (typically a trust entity registered with SEBI as an AIF) is not to be taxed on any income that is earned from investments. The income earned is taxable in the hands of the investors when the VCF or AIF distributes

this to investors. Further, the characterisation of income in their hands is the same as that realised or distributed by the investee company to the fund. On 3 July 2018, SEBI raised the cap for overseas investments in AIFs and VCFs from US$500 million to US$750 million. Investments in AIFs in 2019 rose 53 per cent over 2018, to 1.4 trillion rupees.\(^87\) Further, a restriction on allocating foreign portfolio investors (FPIs) to more than 50 per cent of the securities in a single debt issuance prompted FPIs to use the AIF route to make debt investments into India.

\section{Preferred jurisdictions for offshore funds}

\subsection*{Background}

The primary driver that determines the choice of jurisdiction for setting up India-focused funds is a domicile that has executed a DTA with India. Currently, India has separate DTA agreements with various countries, such as Ireland, Mauritius, the Netherlands and Singapore. The Netherlands has been a popular jurisdiction primarily with portfolio investors. This is because the capital gains tax benefit is available to Dutch entities as long as they hold less than 10 per cent of the shares of an Indian company.

Over the years, Mauritius has been one of the most favoured destinations to set up India-focused funds and accounts for more than 30 per cent of the foreign investment into India. This is because India has a DTA with Mauritius that provides various benefits, such as tax exemption on capital gains, a robust dispute resolution network and the right to repatriate capital and returns.

The benefits under the India–Singapore DTA are available only to entities that reside, or are domiciled, in Singapore. Further, the treaty benefits are linked to satisfaction of certain conditionalities, popularly known as the limitation-of-benefits clause. Unlike the treaty between India and Mauritius, the capital gains exemption under the India–Singapore DTA is linked to satisfaction of the limitation-of-benefits clause, which requires that the affairs of the Singapore entity should not be arranged with the primary purpose of availing itself of the capital gains exemption. In addition, the entity should not be a shell or conduit company.

\subsection*{Recent treaty changes}

The bilateral investment treaty between India and Mauritius was amended on 10 May 2016 pursuant to a protocol signed between the respective governments (the Mauritius Protocol). Pursuant to the Mauritius Protocol, the capital gains tax exemption is being phased out and any capital gains arising from sale of shares (acquired after 1 April 2017 and transferred after 31 March 2019) will be taxable in India at the full domestic rate of 15 to 20 per cent. Further, shares transferred before 31 March 2019, will be taxed at 50 per cent of the domestic tax rate of India subject to certain conditions. This phasing out of the capital gains exemption is only applicable to sales of shares and not sales of debentures. Accordingly, sales of debentures continue to enjoy tax benefits under the India–Mauritius DTA, making Mauritius a preferred destination for debt investments.

Further, prior to the Mauritius Protocol, India did not have the right to tax any residuary income of a Mauritian tax resident arising in India. The Mauritius Protocol has now enabled India to tax ‘other income’ arising from a Mauritian tax resident in India. In addition, the

\footnote{\url{www.business-standard.com/article/pti-stories/aif-investment-rises-to-rs-1-4-lakh-cr-in-dec-quarter-12002130128_1.html}.}
Financial Services Commission of Mauritius has introduced domestic substance rules to determine whether Mauritius-based entities are managed and controlled in Mauritius. India and Mauritius have also agreed to assist each other to collect revenue claims, upon a request from each other’s revenue authorities. All such measures, viewed cumulatively, signal India’s serious resolve to curb tax avoidance. From the investor or fund’s perspective, the phased withdrawal of capital gains tax exemption will give investors time to reassess their investment structures in relation to India.

The amendments to the India–Mauritius DTA have made it a significantly less popular destination for making investments. In addition, the announcement made by the Prime Minister of Mauritius in the country’s budget in June 2018 indicates a potential 3 per cent tax liability on Mauritian FPIs earning dividend income from Indian shares.

The capital gains exemption under the India–Singapore DTA was coterminous with the capital gains exemption under the India–Mauritius DTA. Thus, taking its cue from the Mauritius Protocol, the respective governments of India and Singapore signed a protocol amending the India–Singapore DTA, introducing source-based taxation for capital gains arising upon transfer of shares (acquired on or after 1 April 2017) and enabling the application of domestic laws to curb tax avoidance or tax evasion. This language allows the Indian government to apply the GAAR even in situations where a specific anti-avoidance provision exists in the DTA.

**Singapore or Mauritius**

Although Singapore is no longer a relevant jurisdiction for investors seeking to take advantage of tax arbitrage, Singapore is taking various steps to attract foreign investors, including by introducing the concept of a Singapore variable capital company (SVCC) to be used as a vehicle for investment. The SVCC is expected to simplify the process of redemption of open-ended funds. Currently, the redemption of open-ended funds is a long-drawn-out process involving drawing up of accounts, audit and issuance of a solvency certificate. Singapore also enjoys an edge over Mauritius because of its outstanding banking facilities, access to financial products and better talent, thus causing a shift of funds from Mauritius to Singapore.

The choice of jurisdiction assumes more importance for FPIs since the securities held by an FPI are considered capital assets and the gains derived from their transfer are considered capital gains. Therefore, funds that have so far taken the position that this kind of income qualifies as business income may have to revisit their structures to ensure that they operate from jurisdictions that allow them to obtain relief on paying the applicable tax in India.

**vii Investment route for offshore funds**

**Foreign direct investment route**

Investors typically route their investments in an Indian portfolio company through a foreign direct investment (FDI) vehicle if the strategy is to play an active part in the business of the company. FDI investments are made by way of subscription or purchase of securities, subject to compliance with the pricing guidelines, sectoral caps and certain industry-specific conditions. Such investments are governed by the rules and regulations set out under the FDI consolidated policy (the FDI Policy), which is issued every year by the DPIIT of the Ministry of Commerce and Industry, and the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 (the Non-Debt Rules). The Non-Debt Rules supersede the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2017. While the changes introduced in the Non-Debt Rules were originally
not substantial, many changes have been pushed through individual amendments since its notification. Under the Non-Debt Rules, in line with the erstwhile regulations, any investment of 10 per cent or more of the post-issue paid-up equity capital on a fully diluted basis of a listed company will be reclassified as an FDI. In addition, the Non-Debt Rules stipulate that the pricing of convertible equity instruments is to be determined upfront and the price at the time of conversion should not be lower than the fair value at the time of issue of such instruments.

The Non-Debt Rules have been aligned with the SEBI (Foreign Portfolio Investors) Regulations 2019 (the FPI Regulations) to provide that an FPI may purchase or sell equity instruments of an Indian company that is listed or to be listed subject to the individual limit of 10 per cent (for each FPI or an investor group) of the total paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants issued by an Indian company. The aggregate holdings of all FPIs put together (including any other permitted direct and indirect foreign investments in the Indian company) are subject to a cap of 24 per cent of the paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants. Such aggregate limit of 24 per cent can be increased by the concerned Indian company to up to the sectoral cap or statutory ceiling (as applicable) by way of a board resolution and a shareholders’ resolution (passed by 75 per cent of the shareholders).

Previously, any investment in excess of the sectoral caps or not in compliance with the sectoral conditions required prior approval of the Foreign Investment Promotion Board (FIPB). In furtherance of its announcement in 2017, the government abolished the FIPB in 2017. In place of the FIPB, the government has introduced an online single-point interface for facilitating decisions that would previously have been taken by the FIPB. Upon receipt of an FDI application, the administrative ministry or department concerned will process the application in accordance with a standard operating procedure (SOP) to be followed by investors and various government departments to approve foreign investment proposals. As a part of its initiative to ease business further, the SOP also sets out a time limit of four to six weeks within which different government departments are required to respond to a proposal. More than two years on, there is very little information in the public domain about the proposals processed by the SOP.

**FPI route**

Foreign investors who have a short investment horizon and are not keen on engaging in the day-to-day operations of the target may opt for this route after prior registration with a designated depository participant (DDP) as an FPI under the FPI Regulations. The FPI Regulations supersede the erstwhile SEBI (Foreign Portfolio Investors) Regulations 2014 (the 2014 Regulations). The process of registration is fairly simple and ordinarily it does not take more than 30 days to obtain the certificate.

In 2014, to rationalise different routes for foreign portfolio investments and create a unified and single-window framework for foreign institutional investors, qualified institutional investors and sub-accounts, SEBI, the security watchdog, introduced the regulations on FPIs. In December 2017, SEBI, with the intention of providing ease of access to FPIs, approved certain changes to the FPI Regulations, which included: (1) rationalisation of fit-and-proper criteria for FPIs; (2) simplification of the broad-based requirement for FPIs; (3) discontinuation of requirements for seeking prior approval from SEBI in the event of a change of local custodian or FPI DDP; and (4) permitting reliance on due diligence carried
out by the erstwhile DDP at the time of the change of custodian or FPI DDP. In addition, with a view to improve ease of doing business in India, a common application form has been introduced for registration, the opening of a demat account and the issue of a permanent account number for the FPIs.

In 2019, SEBI introduced the FPI Regulations, with certain important changes from the 2014 Regulations, including:

a the re-categorisation of FPIs into two FPI categories (rather than the three FPI categories under the 2014 Regulations). This will be done by the National Securities Depository Limited in consultation with the respective FPI DDPs;

b for investment in securities in India by offshore funds floated by an asset management company that has received a no-objection certificate under the SEBI (Mutual Funds) Regulations 1996, registration as an FPI will have to be obtained within 180 days of the date of the FPI Regulations;

c the broad-based requirement (where the fund was required to be established by at least 20 investors) for certain categories of FPIs has been done away with;

d the concept of opaque structure has now been removed from the FPI Regulations such that the entities that are incorporated as protected cell companies, segregated cell companies or equivalent structures, for ring-fencing of assets and liabilities, can now seek registration as FPIs under the FPI Regulations. Having said that, under the 2014 Regulations, where the identity of the ultimate beneficial owner was accessible, such entities could fall outside the scope of opaque structures and, hence, obtain registration as an FPI. Similarly, while the concept of opaque structures has been removed under the FPI Regulations, FPIs need to mandatorily comply with the requirement of disclosure of beneficial owners to the SEBI; and

e the total investment by a single FPI, including its investor group, must be below 10 per cent of a company’s paid-up equity capital on a fully diluted basis. If this threshold is exceeded, the FPI needs to divest the excess holding within five trading days of the date of settlement of trades resulting in the breach. The window of five trading days allows FPIs to avoid any change in the nature of their investments. However, upon failure to divest the excess holding, the entire investment in the company by the FPI (including its investor group) will be treated as an FDI, and the FPI (including its investor group) will be restricted from making further portfolio investments in terms of the FPI Regulations.

The clubbing of investment limits for FPIs is done on the basis of common ownership of more than 50 per cent or on common control. As regards the common-control criteria, clubbing shall not be done for FPIs that are: (1) appropriately regulated public retail funds; (2) public retail funds that are majority owned by appropriately regulated public retail funds on a look-through basis; or (3) public retail funds whose investment managers are appropriately regulated. The term ‘control’ is understood to include the right to appoint a majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights, by shareholders’ or voting agreements, or in any other manner.

Under the original FPI regime, Category I FPIs were restricted to those who were residents of a country whose securities market regulator was either a signatory to the International Organization of Securities Commission’s Multilateral Memorandum or had a
bilateral memorandum of understanding with SEBI. Hence, Category I FPIs were essentially governments and related entities or multilateral agencies and were perceived to be the highest-quality and lowest-risk investors.

Pursuant to the reclassification of FPIs, the entities that have been added to Category I, inter alia, are:

a. pension funds and university funds;

b. appropriately regulated entities, such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisers, portfolio managers, broker dealers and swap dealers;

c. appropriately regulated funds from Financial Action Task Force member countries;

d. unregulated funds whose investment manager is appropriately regulated and registered as a Category I FPI; and

e. university-related endowments of universities that have been in existence for more than five years.

In addition, the Category II FPI is the new residual category, which includes all the investors not eligible under Category I, such as individuals, appropriately regulated funds not eligible as Category I FPIs and unregulated funds in the form of limited partnerships and trusts. An applicant incorporated or established in an international financial services centre (IFSC) is deemed to be appropriately regulated under the FPI Regulations.

Market participants have welcomed all these changes as pragmatic steps by SEBI to enhance the flow of institutional capital into India.

**Foreign venture capital investor route**

The foreign venture capital investor (FVCI) route was introduced with the objective of allowing foreign investors to make investments in VC undertakings. Investment by such entities into listed Indian companies is also permitted subject to certain limits or conditions. Investment through the FVCI route requires prior registration with SEBI under SEBI (Foreign Venture Capital Investors) Regulations 2000 (the FVCI Regulations). Investment companies, investment trusts, investment partnerships, pension funds, mutual funds, endowment funds, university funds, charitable institutions, asset management companies, investment managers and other entities incorporated outside India are eligible for registration as FCVCIs. One of the primary benefits of investing through the FVCI route is that FVCI investments are not subject to the RBI's pricing regulations or the lock-in period prescribed by the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018.

Pursuant to the FVCI Regulations, FVCIs must register with SEBI before making investments. The process typically takes 20 to 30 days from the date of application. To promote job creation and innovation, the RBI allowed for 100 per cent FVCI investment in start-ups. In this regard, the Non-Debt Rules also allow FVCIs to purchase equity, equity-linked instruments or debt instruments issued by an Indian start-up, irrespective of the sector in which it is engaged, subject to compliance with the sector-specific conditions (as applicable). Previously, only investment in the following sectors did not require prior approval of the securities regulator:

a. biotechnology;

b. information technology;

c. nanotechnology;

d. seed research and development;
pharmaceuticals (specifically in terms of discovery of new chemical entities); dairy;
poultry; biofuel production;
hotels and convention centres with a seating capacity of over 3,000; and infrastructure.

III THE INSOLVENCY CODE

2019 has been an epochal year for the Insolvency and Bankruptcy Code 2016 (the Insolvency Code). In the three years to November 2019, the Insolvency Code recorded resolution of an aggregate 167 cases, out of which 81 cases were resolved during 2019 itself. The Insolvency Code helped recover 1.57 trillion rupees of unpaid bank loans or money due to vendors, amounting to 42 per cent of the total amount due. These figures comprise cases that were actually brought before the adjudicating authorities. Considering the number of successful resolutions under the Insolvency Code prior to their admission by the adjudicating authority, the Insolvency Code might have helped the recovery of about 5 trillion rupees of unpaid dues. In 2019, the Insolvency Code saw one of the biggest resolutions, and one of the largest FDI inflows, involving an amount of 420 billion rupees for the acquisition of Essar Steel by ArcelorMittal.88

During 2018, a reduction in the voting threshold from 75 per cent to 66 per cent of the committee of creditors (CoC) with respect to key decisions was introduced, which enabled quick decision-making, allowing for approvals of viable resolution plans. In addition, the scope of ‘connected persons’ who were barred from bidding for companies under the Insolvency Code was reduced such that the entities (such as financial entities having connected persons through investee companies in India or abroad) could participate in the bidding process so long as they are not related parties.

Following the trend for changes and clarifications, 2019 also witnessed a number of amendments to the Insolvency Code and the Insolvency and Bankruptcy Board of India (IBBI) (Insolvency Resolution Process for Corporate Persons) Regulations 2016 (the CIRP Regulations) thereunder. One of the key amendments to the Insolvency Code included the grant of immunity to an insolvent company and its assets from prosecution for offences committed prior to the insolvency process, provided that such insolvent company has been acquired by a person who is not connected with the management or such offences. In addition, the time period for resolution of cases under the Insolvency Code, including litigations and other judicial process, has been increased from 270 days to 330 days. One of the amendments also provides that a resolution plan could distinguish between financial creditors on the basis of their priority and value of security interest.

Key amendments to the CIRP Regulations in 2019 include:

a the resolution applicant must furnish the CoC with a performance security pertaining to the nature of the resolution plan and the business of the corporate debtor;

b an authorised representative of a financial creditor will be entitled to cast his or her vote in respect of all financial creditors represented by him or her. Accordingly, the

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waterfall for payments under the resolution plan has been modified to the effect that the dissenting financial creditors will be paid in priority to the financial creditors who voted in favour of the resolution plan;
corporate restructuring of the corporate debtor (by way of merger, amalgamation and demerger) can now be included in the resolution plan; and
d the insolvency professionals and insolvency professional agencies must electronically furnish certain forms to ensure transparency in the corporate insolvency resolution process. Any failure, delay or furnishing of incomplete or incorrect information or records with the form by the insolvency professionals will make them liable for an action under the Insolvency Code by the IBBI.

In addition, the IBBI has notified separate regulations for insolvency resolution processes and bankruptcy proceedings for personal guarantors to the corporate debtors, with effect from 1 December 2019. The regulations on the insolvency resolution process, inter alia, set out the eligibility criteria of the resolution professional, the manner of receipt and verification of claims of creditors, the contents of the repayment plan and the procedure for filing an application for the issuance of a discharge order. Akin to the regulations on the insolvency process, the regulations on the bankruptcy process provide for, inter alia, the eligibility to act as a bankruptcy trustee for the bankruptcy process, the manner of preparation of reports and timeline for submission by the bankruptcy trustee and the manner of realisation of assets of the bankrupt and its distribution. In March 2019, the IBBI also issued an indicative charter of responsibilities of the CoC and resolution professionals for the purpose of clarifying the roles and responsibilities to be discharged by them respectively during the insolvency process.

Apart from the legislative amendments, the Insolvency Code was significantly shaped by verdicts passed by the Supreme Court of India. One of the key developments in the Insolvency Code is the Supreme Court’s decision to uphold the constitutional validity of the Insolvency Code. The Insolvency Code has faced challenges of unconstitutionality on the basis that it, inter alia, provides primacy to financial creditors over operational creditors. In this context, operational creditors will need to calculate ways in which to secure themselves in the eventuality of default of payments by corporate debtors.

The immediate impact of the Insolvency Code is evident from the improvement in India’s ranking by the World Bank on the country’s ability to handle insolvency cases, moving up 33 places to 103rd position. Also in 2018, the National Company Law Tribunal resolved insolvency cases amounting to more than 800 billion rupees, a figure that was predicted to hit the trillion-rupee mark as there were several high-profile deals pending. The trillion-rupee mark was finally hit during 2019, which illustrates the success of the Insolvency Code in India. However, the most significant change is that promoters are behaving better in relation to lenders and no longer enjoying an upper hand when negotiating deals with lenders.

IV SOLICITATION, DISCLOSURE REQUIREMENTS AND FIDUCIARY DUTIES

Typically, investment vehicles issue a private placement memorandum (PPM) or an offer document to raise funds from prospective investors. The PPM sets out all material information to enable the investors to make an informed decision, including fund structure, summary of key terms, background of the key investment team, risk factors, disciplinary history and risk management tools in Category III AIFs.
A lesson learned by the industry in 2019, from SEBI’s interpretation of the AIF Regulations, was for investment managers to pay careful attention while drafting the investment objectives in the PPM.

SEBI reprimanded SREI Multiple Asset Investment Trust and SREI Alternative Investment Managers for not making investments within the specified limits set out in their PPM. Industry experts have criticised the reprimand as misplaced, stating that managers should be afforded the flexibility of conducting their business within the broad framework contained in the marketing document, and the terms contained therein should not be subject to a strict interpretation. Having said that, in accordance with the AIF Regulations, managers and sponsors are beginning to set out the risk of their investments in relation to the minimum amount required to be invested. Since a PPM in India acts as both a marketing and a disclosure document, careful attention has to be paid while drafting the PPM to ensure a fine balance between regulatory requirements prescribed by SEBI and the marketing leverage that they want from their commitments to the fund.

With respect to offshore India-focused funds, the disclosure requirements, marketing guidelines and limits on solicitation are governed by the laws of the fund’s domicile or jurisdiction. While there is no regulatory framework governing the marketing documents of offshore India-focused funds, under the AIF Regulations, AIFs are required to disclose certain financial information, including sharing valuation reports and filing the PPM with SEBI, for domestic funds. Further, there are limitations on the number of investors that an investment vehicle can attract. For instance, no AIF scheme (other than an angel fund) can have more than 1,000 investors.

Recognised as fiduciaries, directors of an investment vehicle are exposed to liabilities, arising out of breach of their duties towards the fund and its stakeholders. Accordingly, directors should be mindful of their duties and exercise a supervisory role, during the entire cycle of a fund. For instance, at the time of fund formation, a director should ensure that the structure of the fund is tax-compliant, and that the information set out in the offer documents is not untrue or misleading. During the life of the fund, the directors should ensure policies regarding conflicts of interest are in place and adhered to.

Similar principles are built into the AIF Regulations and the REIT Regulations, which require the sponsor and the manager to act in a fiduciary capacity towards their investors and disclose any potential conflicts of interest.

V  TAXATION

i  Taxation of foreign funds

Following the adoption of the GAAR on 1 April 2017, the Indian tax authorities have the ability to treat arrangements outside India as an ‘impermissible avoidance arrangement’ if the main purpose of the arrangement is to obtain a tax benefit and the arrangement has no ‘commercial substance’. Mere location of the entity in a tax-efficient jurisdiction will not invoke the GAAR. Accordingly, it is critical for a fund to demonstrate commercial reasons for setting up a fund in a particular jurisdiction. The steps that a fund may undertake to demonstrate commercial reasons include the renting of office space, and employment of personnel in that jurisdiction.

The other potential taxation risk in India for offshore funds is the risk of being perceived to have a permanent establishment in India on account of the fund’s relationship with the investment advisory team based in India, in which case it would be liable to tax in India.
As stated earlier, when determining POEM and actual residency status of an entity, the key guiding principle is whether the entity is engaged in ‘active business outside India’. To protect itself from any exposure to charges of having a permanent establishment, a fund must, inter alia, demonstrate that decision-making for the fund is being undertaken at the offshore fund level and not in India. To encourage fund management in India, the Finance Act 2015 provided for safe-harbour rules, where fund management activity carried out through an eligible fund manager in India by an eligible investment fund shall not constitute a business connection in India, subject to the fund and fund manager satisfying various restrictions, such as participation or investment by persons resident in India to be limited to 5 per cent, and a prohibition on the fund making any investment in its associate entity and carrying on or controlling and managing any business in India or from India.

ii Taxation of domestic funds

The Finance Act 2015 conferred tax pass-through status upon Category I and Category II AIFs. Accordingly, the income from investment is not taxed in the hands of such funds but is taxed in the hands of the unitholders. The taxation of Category III AIFs depends on the legal status of the fund (i.e., company, limited liability partnership or trust). Accordingly, investment fund income, other than the business income, is exempt from tax and income received by or accrued to Category I and Category II AIF unitholders is chargeable to tax in the same nature and in the same proportion as if it were income received by or accrued to the unitholder had the investment been made directly by the unitholder. This amendment has provided long-awaited clarity to AIFs given that, prior to this amendment, AIFs were subject to trust taxation provisions that posed several tax uncertainties.

On similar lines, amendments were made to provide pass-through status to REITs and InvITs. Taxes are imposed on these in the manner set out below.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>SPVs</th>
<th>REITs</th>
<th>Sponsor/investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>Exempt subject to conditions</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Interest</td>
<td>No withholding</td>
<td>Exempt</td>
<td>Taxable</td>
</tr>
<tr>
<td>Rental income (only applicable for REITs, not InvITs)</td>
<td>No withholding</td>
<td>Exempt</td>
<td>Taxable</td>
</tr>
<tr>
<td>Capital gains</td>
<td>N/A</td>
<td>Taxable</td>
<td>Exempt</td>
</tr>
<tr>
<td>Other income</td>
<td>N/A</td>
<td>Taxable</td>
<td>Exempt</td>
</tr>
</tbody>
</table>

Further, tax implications for different streams of income in the hands of the investors are set out below.

**Dividends**

Dividends declared by Indian companies are exempt from tax in the hands of the investors. The investee companies are liable to pay dividend distribution tax on the net dividend distributed in the hands of the investee companies at the rate of 20.55 per cent of the dividend imposed on the distributing company.
Interest
Interest income is subject to tax in the hands of Indian resident investors at the rate that would otherwise apply to the investors on their ordinary income. Income from interest on debt ranges from 5.46 per cent to 43.68 per cent, depending on the regulatory regime, currency of debt and rate of interest.

Capital gains
Any short-term capital gain arising on the transfer of listed shares on any recognised stock exchange in India, where securities transaction tax is payable, is subject to tax at the rate of 15 per cent (plus applicable surcharge and cess) subject to any tax benefit under the relevant tax treaty in the case of both residents and non-residents. Sales off the market that result in short-term gain are subject to tax at the rate of 40 per cent (plus applicable surcharge and cess) subject to any tax benefit under the relevant tax treaty in the case of non-residents and at the rate of 30 per cent (plus applicable surcharge and cess) in the case of residents.

Any long-term gain exceeding 10,000 rupees on transfer of listed shares by both residents and non-residents on any recognised stock exchange in India, where securities transaction tax is payable, is subject to tax at the rate of 10 per cent (without the benefits of indexation and neutralisation of foreign exchange fluctuation) and where the transfer is made after 1 April 2018 and off the market, it is subject to a tax of 10 per cent (without the benefits of indexation and neutralisation of foreign exchange fluctuation).

In addition, the government has revised Section 56(2)(viib) of the Income Tax Act 1961 to exempt investments received from Category II AIFs from the applicability of angel tax with effect from 1 April 2020. Previously, this exemption was limited to investments received from Category I AIFs. This amendment is expected to encourage investments by Category II AIFs; this category includes the majority of AIFs in India.

Losses
With effect from 1 April 2020, any accumulated losses (in the nature of business loss) incurred by Category I or Category II AIFs will be passed to the investors who will be able to set these off against their income, provided that they have held units in the AIF for longer than 12 months. In addition, with effect from 1 April 2020, any accumulated losses (not in the nature of business losses) incurred by Category I or Category II AIFs prior to 31 March 2019 will be passed to the investors, subject to the condition that they held units in the AIF on 31 March 2019. Accordingly, such losses can be carried forward and set off by the investors against their income from the year in which the loss had first occurred, taking that year as the first year in accordance with Chapter VI of the Income Tax Act. However, such pass-through benefit of losses will not be available to investors who acquired units of AIFs on or after 1 April 2019.

Offshore investments
By way of a circular dated 3 July 2019, the Central Board of Direct Taxes has clarified that any income in the hands of a non-resident investor from offshore investments routed through a Category I or Category II AIF that is deemed a direct investment outside India is not taxable in India under Section 5(2) of the Income Tax Act. The circular further clarified that any exempt loss arising from the offshore investment by a non-resident investor may not be set off or carried forward against the income of the Category I or Category II AIF. This clarification essentially prevents double taxation of the non-resident investor’s income in India and in its country of residence.
The Finance Act 2019 exempts taxation of income arising from the transfer of global depository receipts, rupee-denominated bonds and derivatives on a stock exchange in an IFSC, for non-resident investors of Category III AIFs, provided that the income is solely in the form of convertible foreign exchange and all units of the AIFs are held by non-residents (except for units held by the sponsor or manager). This exemption is a positive step to boost offshore funding raising by Category III AIFs in an IFSC.

In addition, the Finance Act 2019 provides an exemption to a unit (as defined under the Special Economic Zones Act 2005) operating from an IFSC from dividend distribution tax in respect of dividends distributed from income accumulated by such unit from its operations in the IFSC from 1 April 2017. Similarly, the distributions made by mutual funds located in IFSCs, which derive income solely in the form of convertible foreign exchange and all units of which are being held by non-residents, are exempted from the levy of dividend distribution tax. Unlike Category III AIFs located at IFSCs, the manner of non-resident holding in such mutual funds has not been provided.

VI KEY INVESTMENT TERMS

As the alternative investment market in India continues to mature through the involvement of more sophisticated LPs, reporting requirements have become more complex and demanding. Each LP is looking to closely monitor the ways in which the GP is putting the capital to work. Consequently, LPs now include back-office management and reporting as key items on their due diligence checklist when determining which funds to invest in. In addition, reporting requirements have become robust enough to ensure complete visibility of the operating status of portfolio investments.

Over the years, LPs have become much more vocal in their demands for transparency in investment decision-making as well. Accordingly, the nature of the rights of the investment and advisory committees, and seeking a seat on these committees, have become key points of negotiation between LPs and GPs. LPs are also demanding a veto with respect to each investment decision made by the investment committee. In addition, any transaction involving a potential conflict of interest is expected to be referred for resolution to an advisory board consisting of representatives from the LPs.

LPs are also demanding a veto right with respect to critical decisions such as capital deployment, appointment of key personnel, conflicts of interest and sector focus. A positive trend witnessed has been LPs getting involved with the day-to-day operations of the portfolio companies and sharing sectoral expertise to expand the businesses. With many development finance institutions acting as LPs, funds are being compelled to follow international benchmarks with respect to governance, anti-corruption, and environmental and social norms. This increased involvement of LPs in the decision-making process is being driven by a number of factors, such as an unprecedented run-up in sizes, persistent under-performance and unexpected liquidity pressures on LPs.

To attract more LPs, GPs in India are amenable to moving away from the classic ‘2 and 20’ fee–carry model. Since management fees have no bearing on the performance of the portfolio investments, LPs are unwilling to take risks with respect to the percentage of the management fee. When it comes to the amount on which the management fee is being calculated, LPs are demanding that during the commitment period, fees be calculated as a percentage of the capital commitments made to a fund. After the commitment period,
the fee should be calculated as a percentage of the capital contribution that has not been returned to the LPs. Further, LPs are opting for co-investment structures, which results in an overall reduction in the fees that LPs pay to GPs. To diversify an LP’s risk, waterfalls are being structured to allow LPs to invest on a deal-by-deal basis or on a blind-pool basis. In addition, at the time of formation of the fund itself, GPs are asked to provide a fee model to act as a guide, to assess and set management fees. Further, distribution of carried interest is being structured on a staggered basis such that allocation of carry is proportionate to the returns achieved by the fund.

Owing to the administrative hassle of managing too many GP relationships, powerful and large LPs are cherry-picking the GPs they want to deal with. LPs are willing to bet their money on decently sized GPs who have a consistent track record. The operational due diligence on GPs has become highly detailed, with meticulous data analysis being conducted as a part of the GP selection process. Other than the standard performance metrics, such as internal rate of return, detailed past-performance figures are being taken into account when conducting due diligence checks.

LPs are also expressing concerns about the expenses that are charged to a fund, and are always looking to cap the expenses incurred by GPs, either as a fixed amount or a percentage of the total size of the fund. In the event that the LPs and GPs agree to an annual cap on operating expenses, LPs want the right to be consulted before GPs set the annual cap.

With increased scrutiny of the fund structures by tax authorities, GPs have successfully negotiated for clawback clauses from LPs to cover future tax liabilities. While LPs fight to limit the scope of such clauses to a certain fixed period, this may not be acceptable in the Indian context given the long limitation period available to the tax authorities to proceed against funds.

The changing dynamics between LPs and GPs has given both parties an opportunity to remodel the Indian private equity space into a more sophisticated market. Practically speaking, perfect alignment of the LPs’ and GPs’ interests is close to impossible. However, if Indian GPs have to keep the funds flowing from LPs, GPs must get into the habit of making adjustments to the agreed fund terms and conditions.

VII REGULATORY DEVELOPMENTS

i Amendments to FDI Policy

The DPIIT made certain noteworthy changes to the FDI Policy during 2019 in its attempt to make India an attractive destination for FDI flows. Such changes include the following:

a 100 per cent FDI is now permitted under an automatic route in entities that are engaged in the sale of coal and coal mining activities including coal washing, crushing, handling and separation (magnetic and non-magnetic);

b 100 per cent FDI is now permitted under an automatic route for contract manufacturing and, accordingly, the entity with the FDI can undertake the manufacturing activities itself or through contract manufacturing, on either a principal-to-principal basis or a principal-to-agent basis. It has been clarified by the DPIIT that the investee entity will be deemed to be a manufacturing entity itself even if the manufacturing is done by a third-party contractor, provided that it is done under a legally tenable contract. In addition, the entity that has outsourced the manufacturing to the third-party contractor will be eligible to sell the manufactured product through wholesale, retail or e-commerce on the same footing as an entity that manufactures directly; and

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26 per cent FDI has been permitted under the approval route in entities that are engaged in uploading or streaming news and current affairs through digital media.

ii National Guidelines on Responsible Business Conduct 2019

The Ministry of Corporate Affairs (MCA) has revised and updated the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business of 2011 and issued the National Guidelines on Responsible Business Conduct 2019 (NGRBC). The revised guidelines have been aligned with the United Nations (UN) Sustainable Development Goals, the UN Guiding Principles for Business and Human Rights, the Paris Agreement on Climate Change, International Labour Organization core conventions Nos. 138 and 182 on child labour, and annual business responsibility reports mandated by SEBI and the Companies Act 2013, including recent amendments with respect to corporate social responsibility.

As with the earlier guidelines, the NGRBC is designed to assist businesses to perform above and beyond the requirements of regulatory compliance. The NGRBC applies to all businesses irrespective of their ownership, size, structure or location, including foreign multinational corporations investing or operating in India. They are also a guide for Indian multinational companies in their overseas operations. They encourage businesses to not only follow these guidelines in the context of business over which they have direct control and influence but also for their suppliers, vendors, distributors and collaborators. A committee on business responsibility reporting constituted by the MCA will develop formats for listed and unlisted companies to report on their business responsibilities. This is expected to boost investor confidence and increase their creditworthiness.

iii REITs and InvITs

The MCA has amended the Companies (Acceptance of Deposits) Rules 2014 (the Deposit Rules) to exclude any amount received by a company from a REIT from the purview of ‘deposit’ under Rule 2(1)(c)(xviii) of the Deposit Rules. This follows the previous amendments, which excluded amounts received from AIFs, domestic VCFs, InvITs and mutual funds registered with SEBI.

In April 2019, SEBI notified amendments to the REIT Regulations and the Infrastructure Regulations. Some of the key changes include a reduction in the minimum subscription from any investor in any publicly issued InvIT from 1 million rupees to 100,000 rupees. In the case of a publicly listed REIT, the minimum subscription amount has been reduced from 200,000 rupees to 50,000 rupees. In addition, the minimum trading lot has been reduced from 500,000 rupees to 100,000 rupees. This is expected to increase the reach of retail investors to real estate and infrastructure projects, which was earlier limited due to high minimum investment requirements involved in investments through AIFs. Prior to the 2019 amendments, the aggregate consolidated borrowings and deferred payments of a listed InvIT, its holding company and SPVs were capped at 49 per cent of the value of InvIT assets, which restricted the ability of InvITs to make further acquisitions and provided for limited returns as compared to AIFs. Such limit has now been increased to 70 per cent of the value of InvIT assets subject to certain conditions such as obtaining a prior approval of 75 per cent of the unitholders and utilisation of funds only for the purpose of acquisition or development of the infrastructure projects or real estate projects. Unlisted private InvITs have received a much-anticipated relaxation of the rules in terms of the minimum number of investors, which is now at the discretion of the InvITs (capped at 20 members). The leverage limit of these private InvITs is to be specified under the trust deed (in consultation with the investors).
SEBI has also issued certain clarifications in relation to InvITs that issue units on a private placement basis, which are proposed to be listed. With effect from 15 January 2020, a draft placement memorandum is to be filed with SEBI and recognised stock exchanges through a SEBI-registered merchant banker, at least 30 days prior to the opening of the issue. The memorandum must contain disclosures as specified in the Infrastructure Regulations and should be submitted along with a due diligence certificate issued by the merchant banker. Upon perusal of the placement memorandum, SEBI may issue observations (if any) on such placement memorandum within 15 days of the later of: (1) receipt of the draft memorandum, (2) receipt of additional information or clarification from the issuer or the regulatory authority, (3) receipt of an in-principle approval from the stock exchanges, or (4) receipt of clarification or information from any regulator or agency, where SEBI has sought any clarification or information from such regulator or agency. It is the merchant banker’s responsibility to ensure that all such comments are suitably incorporated in the draft placement memorandum and provide a due diligence certificate as per the prescribed format.

iv Harmonisation of IFSC-incorporated AIF investment provisions

In August 2019, SEBI harmonised the provisions governing investments by AIFs incorporated in IFSCs with the provisions governing investments applicable to domestic AIFs such that the AIFs incorporated in IFSCs are permitted to make investments in accordance with the provisions of the AIF Regulations. This is in furtherance of SEBI’s endeavour to encourage fund managers to incorporate AIFs in an IFSC. In November 2018, SEBI prescribed detailed operating guidelines to regulate AIFs in India’s first IFSC set up under Section 18(1) of the Special Economic Zones Act 2005 in Gujarat International Finance Tec-City. These actions are in furtherance of the guidelines prescribed in 2015 to facilitate and regulate the securities market at the IFSC. The operating guidelines allow AIFs in the IFSC to invest through the FVCI, FDI or FPI route. Previously, AIFs in the IFSC were allowed to invest only through the FPI route. In addition, the caps applicable to AIFs (see Section II.iv) will not be applicable to an AIF set up in the IFSC. The guidelines provide global investors a more viable option to set up global funds in the IFSC in the form of an AIF.

v Amendments in the Significant Beneficial Owners Rules

The MCA has notified amendments to the Companies (Significant Beneficial Ownership) Rules 2018 (the SBO Rules). The amendments, inter alia, pertain to widening the definition and scope of significant beneficial owners (SBO) and include stringent provisions on disclosure of such ownership by a company. However, the SBO Rules do not apply to SEBI-registered investment vehicles such as mutual funds, AIF, REITs or InvITs. In addition, the SBO Rules do not apply to holding companies that have filed a declaration with the registrar of companies (RoC) in the prescribed form.

The SBO Rules define SBO to mean an individual who, acting alone or together, or through one or more persons or trust, possesses one or more of the following rights or entitlements in the reporting company: (1) holds indirectly, or together with any direct holdings, not less than 10 per cent of the shares; (2) holds indirectly, or together with any direct holdings, not less than 10 per cent of the voting rights in the shares; or (3) has right to receive or participate in not less than 10 per cent of the total distributable dividend, or any other distribution, in a financial year through indirect holdings alone, or together with any direct holdings. Any individual who does not hold any right or entitlement indirectly as per (1), (2) or (3) shall not be considered to be an SBO under the SBO Rules.
In addition, the SBO Rules specify the criteria as to when an individual shall be considered to directly hold a right or entitlement in a company: (1) the shares in the reporting company representing such right or entitlement are held in the name of the individual; or (2) the individual holds or acquires a beneficial interest in a company and has made a declaration in this regard to the company. An individual is deemed to indirectly hold a right or entitlement in a company where the member of the company is a body corporate (whether incorporated or registered in India or abroad), other than a limited liability partnership, and the individual holds the majority stake in that member or holds the majority stake in the ultimate holding company (whether incorporated or registered in India or abroad) of that member. The term ‘majority stake’ means holding more than 50 per cent of the equity share capital or voting rights in the body corporate or having the right to receive or participate in more than 50 per cent of the distributable dividend or any other distribution by the body corporate.

A new provision has been inserted into the SBO Rules, which requires every company to identify its SBO and ensure he or she files a declaration with the RoC. Every reporting company needs to, in all cases where a member (other than an individual) holds not less than 10 per cent of its (1) shares; (2) voting rights; or (3) right to receive or participate in the dividend or any other distribution payable in a financial year, give notice to such member to provide information in prescribed form.

vi Clarification on the appointed date

In view of differing judgements on whether the ‘appointed date’ in schemes of mergers and amalgamations filed under Section 232 of the Companies Act 2013 should be a specified date preceding the sanctioning of the scheme or filing of the certified copy with the RoC, or thereafter, once the MCA has issued a clarification on the interpretation of appointed date clarifying that companies may choose the appointed date of the merger or amalgamation based on occurrence of an event, which allows such companies to function independently until such event actually materialises. However, in the case of an event-based date being a date subsequent to the date of filing the order with the RoC under Section 232(5), the company shall file an intimation of the same with the Registrar within 30 days of such scheme coming into force. Such appointed date identified under the scheme shall also be deemed to be the acquisition date and date of transfer of control for the purpose of conforming to accounting standards (including Indian Accounting Standard 103, Business Combinations).

vii Integrated online reporting of foreign investments and filing of annual returns

To simplify the reporting process of foreign investments, the RBI released the single master form (SMF) with effect from 1 September 2018. With the implementation of the SMF, the reporting of FDI (which is presently a two-step procedure, namely the submission of an advance remittance form (ARF) and a foreign collaboration – general permission route (FC-GPR) form), has been merged into a single revised FC-GPR. Five forms (FC-GPR, FC-TRS, LLP-I, LLP-II and CN) were available for filing using the SMF. Since 1 September 2018, all new filings for these five form categories must be done using the SMF only. In addition, the RBI has introduced the Foreign Liabilities and Assets Information Reporting System, a web-based reporting portal, via a circular dated 28 June 2019, for the purpose of replacing email-based reporting of foreign liabilities and assets of Indian companies, FDI received by Indian companies, and inward and outward foreign affiliate trade statistics.
**viii  Class action under the Companies Act 2013**

The MCA has revised the requisite number of members for filing an application for a class action on the ground that the management or affairs of the company are being conducted in a manner that is prejudicial to the interests of the company in the following manner:

1. the lower of at least 5 per cent of the total members of the company or 100 members, in the case of a company having a share capital;
2. members holding not less than 5 per cent of the issued share capital of the company, for an unlisted company; or
3. members holding not less than 2 per cent of the issued share capital of the company, for a listed company.

**ix  Draft National e-Commerce Policy**

In February 2019, the DPIIT issued the Draft National e-Commerce Policy, which primarily aims to create a conducive regulatory framework for development of the e-commerce sector, empowering domestic entrepreneurs, leveraging access to data, ensuring infrastructure development and stimulating the participation of MSMEs, start-ups and traders in the digital economy. It provides for regulating cross-border data flows while enabling sharing of anonymised community data. Any data not collected in India, any business-to-business data shared between business entities, data flow through software having no personal or community implications and data (excluding data generated by users in India from e-commerce, social media activities or search engines) shared internally by multinational corporations are exempted from cross-border data flow restrictions. In addition, it recognises the ‘network effect’ (greater access to data sources resulting in greater likelihoods of success) in M&A transactions by which e-commerce players such as social medial platforms take over potential competitors early and avoid emergence of competition later. An inter-ministerial panel under the DPIIT will be constituted to address stakeholders’ concerns and provide necessary clarifications on issues related to FDI in e-commerce. The policy is expected to come into effect during 2020 and sufficient time will be provided to stakeholders to adapt the policy prospectively.89

**x  SEBI framework for issue of depository receipts**

In October 2019, SEBI introduced a framework for the issue of depository receipts (DRs) pursuant to Section 41 of the Companies Act 2013, the Companies (Global Depository Receipt) Rules 2014 and the Depository Receipts Scheme 2014. In light of the recent RBI and central government notifications amending the definition of permissible jurisdiction and amendments to the Prevention of Money Laundering Act (Maintenance of Records) Rules 2005, it has been clarified that only a company incorporated in India and listed on a recognised stock exchange in India may issue permissible securities and their holders may transfer such securities for the purpose of issuing DRs subject to the compliance of the requirements in relation to the eligibility, permissible jurisdictions and international exchanges, compliance with extant laws, permissible holder requirements, voting rights and pricing and obligations of the Indian depository, foreign depository and the domestic custodian.

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Key tax proposals under the Finance Bill 2020

The Finance Bill 2020, presented on 1 February 2020, seeks to give effect to the financial proposals of the central government for the financial year 2020–2021. Some of the key tax proposals announced in the Finance Bill are summarised below.

Any income of a sovereign wealth fund in the nature of dividend, interest or long-term capital gains arising from an investment made by it in India on or before 31 March 2024 and held for at least three years, whether in the form of debt or equity in a company or enterprise carrying on the business of developing or operating and maintaining, or developing, operating and maintaining any infrastructure facility or any other notified business, are proposed to be exempted from tax under the Finance Bill. Such exemption is granted to sovereign wealth funds that fulfil certain conditions, inter alia: (1) the fund is wholly owned and controlled (directly or indirectly) by the government of a foreign country; (2) the fund does not undertake any commercial activity whether within or outside India; (3) the fund is set up and regulated under the law of such foreign country; and (4) assets of the fund vest in the government of such foreign country upon dissolution.

To incentivise offshore funds to set-up their management arm in India, these have been granted exemption from the purview of business connection (so as to avail exemption from income tax in India), subject to fulfilment of certain conditions, inter alia: (1) the aggregate participation or investment in the fund, directly or indirectly, by persons resident in India should not exceed 5 per cent of the corpus of the fund; and (2) if the fund has been established or incorporated in the financial year under review, the corpus of the fund should not be less than 1 billion rupees at the end of a six-month period from the last day of the month of its establishment or incorporation, or at the end of such financial year, whichever is later. Following certain practical difficulties in achieving the objective of such exemptions, the Finance Bill relaxes the aforesaid conditions to the extent that any contribution by an eligible fund manager during the first three years, up to 250 million rupees, will not be included for calculation of aggregate participation or investment in the fund. In addition, if the offshore fund has been established or incorporated in the previous year, the corpus of the fund should not be less than 1 billion rupees at the end of a 12-month period from the last day of the month of its establishment or incorporation.

Another important development proposed by the Finance Bill is to abolish the levy of dividend distribution tax (currently at the rate of 20.56 per cent) on the distribution of dividend. It is proposed to shift the tax burden from the company, mutual fund or business trust to the shareholders or unitholders, through tax deduction at source. To remove the cascading effect on taxation of dividend, income from dividends received from a domestic company by another domestic company will be deducted from the total income of such recipient company, to the extent of dividend distributed by such recipient company one month prior to the return filing date. However, business trusts will continue to enjoy tax-free receipt of dividend from investee companies. Moreover, the Finance Bill proposes to do away with the requirement of listing units of business trusts (i.e., InvITs and REITs) on a recognised stock exchange for the purpose of availing tax incentives.

In an attempt to adopt the principal purpose test90 outlined in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit

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90 The principal purpose test is a test to be used by tax authorities to determine if the primary purpose of making an investment through a jurisdiction has been to obtain a tax benefit, and, if so, establishes that a taxpayer would be denied the benefit of the double taxation avoidance agreement (DTAA).
India

Shifting (MLI),\textsuperscript{91} the Finance Bill proposes to amend the Income Tax Act to empower the Indian government to enter into a double taxation avoidance agreement (DTAA) with another country (for, inter alia, avoidance of double taxation) without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in a DTAA for the indirect benefit of residents of any third country or territory). Upon such amendment, the benefits that can be availed by a taxpayer under a DTAA will be subject to the principle purpose test.

VIII OUTLOOK

Despite the Indian economy facing a slowdown, PE/VC investment continued to see a steady rise in 2019. A growth of 28 per cent in PE/VC investment was recorded in 2019, primarily in the infrastructure sector, comprising about 30 per cent of total investment (by value) in 2019 in comparison with only 12 per cent in 2018. The number of deals increased from 769 deals in 2018 to 1,037 deals in 2019, of which 60 per cent were attracted by start-ups. Buyouts emerged as the primary deal type for the PE/VC industry in 2019, accounting for 34 per cent of total PE/VC investment. Such growth in the number of buyouts during 2019 illustrates a shift of Indian PE/VC deals towards the global norm of buyouts being the largest PE/VC deal type. With an approximate value of US$48 million, the Indian PE/VC industry contributed about 1.7 per cent of India’s GDP.\textsuperscript{92}

As we progress into 2020, PE investments are expected to grow by 15 to 20 per cent as a result of India’s growth potential owing to government initiatives, a conducive regulatory framework, enhancement in ease of doing business and encouragement to new avenues of investment (such as REITs and InvITs). Pursuant to such an encouraging trend, PE/VC fundraising is likely to continue to retain investors’ interest during 2020 and the global signs of economic slowdown or deceleration must only be a temporary consideration.

\textsuperscript{91} India has signed and ratified the MLI, which came into force in India on 1 October 2019. The provisions of the MLI will be applicable to more than 30 of the covered DTAAAs and will be applied alongside the existing DTAAAs, thereby modifying their application to implement the anti-base erosion regime.

Chapter 9

ITALY

Enzo Schiavello and Marco Graziani

I GENERAL OVERVIEW

Italian fundraising figures have varied significantly in recent years. Commitments raised by independent fund managers amounted to €2.487 billion in 2015, dropped to €1.313 billion in 2016, reached a €6.239 billion peak in 2017 and then dropped again to €3.415 billion in 2018.² New commitments totalled only €410 million in the first half of 2019, with a reduction of 75 per cent compared with the first half of 2018.³ Of the total 2018 commitments, private fund managers raised €2.738 billion compared to €920 million in 2017.⁴ Of the 2018 commitments raised by private fund managers, 36 per cent was made by international investors, which fell to 27 per cent in the first half of 2019. Pensions funds and other retirement schemes were the larger investors, accounting for an overall 24 per cent of the total commitments in 2018 (17.7 per cent in the first half of 2019). Family offices and individual investors were the second larger investors, however, with commitment reducing from 27 per cent in 2017 to 15.4 per cent in 2018 (17.6 per cent in the first half of 2019). There were 34 firms engaged in raising funds in 2018 (only 14 in the first half of 2019).

Private equity (PE) and venture capital funds raising money in 2018 and 2019 included F2I’s third fund (infrastructure – €3.6 billion at final closing in 2018);⁵ Ambienita III (€635 million at final closing in 2018); Alto Capital IV (€210 million at final closing in 2018); Green Arrow Capital’s Private Equity 3 (€230.6 million at final closing in 2018); Programma 102 (€65 million at first closing in 2018); Italia Venture II – Fondo Imprese Sud (€150 million at first closing in 2018); B4 H II – Fondo EuVeCa (€43 million at first closing in 2018); UV2 (€120 million at final closing announced in 2019); FII Tech Growth (€110 at second closing in 2019); FoF PE Italia (€200 million at first closing in 2019); Fondo Agroalimentare Italiano (€55 million at final closing in 2019); Wise Equity V (€260 million at final closing); IGI Investimenti Sei (€140 million at second closing in 2019); FSI Mid-Market Growth Equity Fund (€1.4 billion at final closing in 2019); Progressio Investimenti III (€250 million at final closing in 2019); Italian Strategy (€50 million at first closing in 2019); Gradiente II (€135 million at final closing in 2019); and Private Equity Arcadia Small Cap II (€80 million at final closing in 2019). With some exceptions reflecting the current market

¹ Enzo Schiavello and Marco Graziani are partners at Legance – Avvocati Associati.
² The figures in this chapter (other than those relating to individual funds) are published by AIFI, the Italian Private Equity, Venture Capital and Private Debt Association.
³ The figures for the second half of 2018 were not available at the time of writing.
⁴ The remaining commitments were raised by institutional fund managers sponsored by Cassa depositi e prestiti. This information is not available for the first half of 2019.
⁵ Including a €1.74 billion rollover of commitments from F2I’s first fund (merged into the third fund).
tendency towards larger commitments concentrated on fewer managers, fundraising periods are generally becoming longer. While public data is not available (and sponsors’ statements about the launch of a fund sometimes do not consider the start date to be the time when fundraising efforts actually commenced), it is not uncommon for a fund to take more than a year to achieve the first closing. Fund terms proposed to investors may include a right of the manager to extend the maximum delay between first and final closing beyond the customary 12 months (generally up to an additional six months) subject to investor consent.

Apart from the perception of the country’s political instability limiting the appetite of large international investors for local funds, other structural factors influence the Italian fundraising landscape, which is not catching up with the significant increase in global fundraising numbers in recent years. Allocations to private equity by Italian pension funds continue to represent a very limited portion of their assets compared to pension funds in other Western countries. Also, pension funds are now more willing than in the past to diversify their PE commitments geographically, and this is reducing allocations to local funds. This situation is unlikely to change rapidly. While Italian managers receive limited support from domestic institutional investors, only some of them have the size, track record and ability to raise funds in the international markets. Another element to note is that sub-threshold managers under Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) are subject to an authorisation requirement pursuant to Italian law. This is making the market for venture capital and other small funds less dynamic and diversified than it was in the pre-AIFMD scenario (when unregulated structures were also available).

Notwithstanding the above, the private equity industry appears to have significant potential for further growth, given the size and dynamism of the Italian economy, the large number of small and medium-sized enterprises (SMEs) that need to optimise their funding sources (still dominated by the banking system) and capture opportunities for export growth, and the new generations of fund managers progressively changing the face of the industry. Tax incentives have been introduced in recent years to foster direct and indirect long-term investment in local SMEs by pension funds.

II  LEGAL FRAMEWORK FOR FUNDRAISING

i  Preferred jurisdictions and legal forms

Italian sponsors typically establish private equity funds as contractual structures governed by Italian law and managed by investment entities authorised and supervised by the Bank of Italy. Establishing funds under the law of another jurisdiction is infrequent for Italian sponsors. In some instances, funds were formed as English limited partnerships considering their particular investor base or the management team’s ability to implement an investment strategy covering multiple jurisdictions.

The transposition of the AIFMD into law did not significantly alter the regulatory framework that was applicable to private equity and other alternative funds beforehand. Collective portfolio management was already a regulated activity requiring prior authorisation, and the conditions to meet for the release of the authorisation were substantially similar to those applying under the AIFMD. This framework applied to both open-end harmonised funds

6 For example, Cassa Forense (lawyers’ pension fund) committed €175 million, as anchor investor, to Asset Management Umbrella Fund, an initiative promoted by the European Investment Fund to offer diversified exposure to funds investing in EU small and medium-sized enterprises.
under EU directives (UCITS) and other funds, including private equity funds (alternative investment funds (AIFs)). However, the definition of collective portfolio management was narrow before the implementation of the AIFMD as it only covered contractual funds and SICAVs, so non-UCITS funds could be established also as unregulated structures. Over time, this gave birth to a number of funds set up as corporate vehicles under ordinary company law.

Because the AIFMD applies to all AIF managers (AIFMs) irrespective of the legal nature of AIFs, this regulatory framework changed with the implementation of the AIFMD. AIFs may now be established in contractual or corporate form, both structures being regulated by law. Also, in implementing the AIFMD, Italy gold-plated its provisions regulating sub-threshold AIFMs by requiring all AIF managers to be authorised (with limited regulatory differences between full-scope and sub-threshold managers).

The regulatory regime applicable to all AIFs requires the appointment of a depositary carrying out safekeeping and other functions in accordance with the AIFMD. Only Italian banks and investment firms (or local branches of EU banks and investment firms) can be authorised by the Bank of Italy to carry out depositary functions. An important distinction between AIFs is based on their permitted investors. If the governing rules of an AIF limit them to certain qualifying investors, the AIF (a reserved AIF) is subject to a more flexible regulatory regime. In particular: (1) commitments to a reserved AIF may be drawn down on an as-needed basis; (2) its constitutive documents are not subject to the prior approval of the Bank of Italy; and (3) the Bank of Italy provisions on limitation and diversification of risk concerning the generality of AIFs do not apply. The governing documents of a reserved AIF must contain provisions setting out, among other things, its investment restrictions, the maximum level of leverage the AIF can employ and the types and sources of permitted leverage.

In this environment, private equity funds are almost invariably set up as closed-end reserved AIFs of a contractual nature. While corporate structures (SICAFs) are also available as alternative legal vehicles, these structures are now subject to comparable regulatory requirements to contractual funds. Because their constitutive documents are more complex than those of contractual funds, corporate vehicles definitely lost appeal compared to the pre-AIFMD (unregulated) scenario. Funds covered by Regulation (EU) No. 345/2013 on European venture capital funds, as amended (the EuVECA Regulation) can be established in Italy as closed-end reserved AIFs taking contractual or corporate form subject to the above considerations. The managers of European venture capital (EuVECA) funds qualify as AIFMs. As such, they are subject to an authorisation requirement in the Italian regulatory system.

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7 Under the AIFMD, a light registration regime applies to sub-threshold AIFMs but national authorities may impose stricter rules.
8 These include (1) professional investors under the AIFMD, (2) entities and individuals making a commitment of €500,000 or more to the AIF, and (3) directors and employees of the AIFM.
9 Private equity funds may not be established as open-end vehicles under Italian regulatory provisions.
10 See footnote 24.
11 Sub-threshold managers of EuVECA funds must be registered in a special roll kept by the Bank of Italy. To obtain this registration, the managers must satisfy conditions mirroring those applicable to sub-threshold AIFMs requesting an authorisation.
Main legal and regulatory provisions

The following are the principal Italian laws and regulations applicable to reserved AIFs and their managers:

a Legislativo Decree No. 58 of 24 February 1998, as amended, is the main piece of legislation regulating financial markets and intermediaries;

b Ministry of Economy and Finance Decree No. 30 of 5 March 2015 regulating the structure of AIFs and other general criteria to be met by them;

c Regulation of the Bank of Italy dated 19 January 2015, as amended, regulating the management of AIFs (including provisions governing the authorisation process and requirements applicable to managers, subsequent ongoing regulatory requirements, supervision and prudential requirements);

d Regulation of the Bank of Italy dated 5 December 2019, setting out the corporate governance and organisational requirements to be met by, among others, AIFMs;

e Regulation No. 20307 of 15 February 2018 of the Italian Securities and Exchange Commission (Consob), setting out rules of conduct applicable to certain intermediaries, including AIFMs, with a view to protecting investor interests; and

f Consob Regulation No. 11971 of 14 May 1999, as amended, regulating issuers of securities and including provisions concerning the marketing of fund interests.

Contractual funds

Fund

A contractual fund is a pool of assets and liabilities created pursuant to a board decision of an authorised manager and segregated by operation of law from all other assets and liabilities of the manager (including those of other funds managed by it), the depositary and the investors. Under the legal segregation rules, the fund’s assets are protected against possible claims and legal actions filed by the creditors of the manager, other funds managed by it, the depositary and the investors. The fund’s creditors may only enforce their claims against the assets of the fund (i.e., not against those of the individual investors, or those of the manager, which is not liable for the fund’s debts to third parties).

The governing rules of a fund and the subscription agreements signed by the investors (in a form prepared by the manager) are the fund’s constitutive documents. The governing rules are approved by the manager when establishing the fund and are accepted by investors by signing their subscription agreements. By accepting the governing rules of a fund, an investor enters into a contractual relationship with the manager that is governed by Italian law. The governing rules of a reserved AIF do not require prior approval from the Bank of Italy; however, the rules must be delivered to the Bank after the AIF is established (reserved AIFs are regulated structures subject to the supervisory powers of the Bank of Italy). Managers can issue side letters to individual investors but any preferential treatment an investor obtains under a side letter or its subscription agreement must comply with fairness and disclosure principles provided for by the AIFMD. Also, side letters and subscription agreements may not contain terms conflicting with those of the fund’s governing rules.
Manager

Contractual funds can be established and managed by Italian authorised managers (SGRs) or other full-scope EU AIFMs acting under AIFMD passport provisions.

SGRs are Italian companies authorised by the Bank of Italy to provide collective portfolio management services. An SGR qualifies as a sub-threshold manager if the volume of its total assets under management is below certain thresholds established by the AIFMD and it has not opted into the full scope of the AIFMD. Sub-threshold SGRs benefit from more relaxed regulatory requirements than full-scope SGRs concerning own funds, remuneration policy, control functions, valuation of assets, outsourcing of manager functions to third parties and some other matters. Unlike full-scope SGRs, sub-threshold managers cannot rely on the AIFMD passport provisions. A company wishing to obtain authorisation as an SGR to manage private equity funds must satisfy a number of conditions, including the following:

1. company limited by shares (legal form);
2. registered office and headquarters in Italy;
3. initial share capital of €500,000 (for full-scope SGRs) or €50,000 (for sub-threshold SGRs);
4. directors, general managers and statutory auditors meeting certain moral, independence, experience, skills, fairness and other requirements;
5. owners of qualifying holdings meeting certain moral, skills and fairness requirements; and
6. group structure not preventing a sound and prudent management and the effective exercise of supervisory functions by the Bank of Italy and Consob. If all applicable legal and regulatory requirements are complied with and the conditions for a sound and prudent management are met, the Bank of Italy will release the authorisation. An authorisation process may take five months or more to complete. Documents to be enclosed with the application include a description of the internal organisation and the main aspects of the proposed policies and procedures of the applicant as well as a regulatory business plan. SGRs are subject to ongoing regulatory requirements concerning the operation of their business, their own funds, reporting duties to the Bank of Italy and Consob, etc.

At present, Italian funds managed by AIFMs of other EU jurisdictions acting under the AIFMD passport provisions represent a very limited portion of the total market. However, the number of EU AIFMs establishing Italian funds is growing as a consequence of tax considerations concerning the proper structuring of Italian investments made from other EU jurisdictions.

SICAFs

SICAFs were introduced in Italy as regulated entities with the implementation of the AIFMD. SICAFs can be formed as reserved AIFs and can be managed internally or by an external manager (an SGR or a full-scope EU AIFM). Unlike contractual funds, externally managed SICAFs cannot be formed unless their prospective founding shareholders obtain an authorisation from the Bank of Italy. Internally managed SICAFs have the double nature of AIFs and managers. An authorisation of the Bank of Italy is required for their formation. This authorisation covers only their internal management (internally managed SICAFs cannot manage other AIFs).

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12 €500 million if the assets are acquired without the use of leverage at fund level and the investors have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF. €100 million in all other cases.

13 Indeed, these SICAFs can retain a number of functions that, in the event of a contractual fund, fall within the responsibilities of an authorised manager (including marketing of shares and valuation of assets).
When the AIFMD was transposed into law, all then existing corporate vehicles carrying out private equity or venture capital investments and falling within the definition of AIF were faced with the alternatives of applying for an authorisation as SICAFs or being liquidated. Many of them opted to continue their investment business as SICAFs and applied for the authorisation. To our knowledge, only a few SICAFs were formed thereafter (mostly in the real estate sector). Contractual funds are indeed simpler legal vehicles, and adopting the corporate form provides no particular tax or other advantage.

**ii  Key legal terms**

Traditionally, the terms of Italian funds targeting only domestic investors are simpler than those seeking commitments from international investors, although the gap is slowly closing and standard fund terms in the private equity arena are becoming the norm also for purely domestic funds.

The Italian regulatory framework has some impact on the terms of private equity funds. Investors may not be granted the right to opt out of specific investments. Italian law indeed provides that investors should share pro rata (in accordance with the rights attached to their class of fund interests) in the income, gains and losses of all portfolio investments of a fund. This makes negotiation on investment restrictions less flexible than it would be with fund vehicles in other jurisdictions as all restrictions should be contained in the fund’s governing rules (not in side letters). Annual and semi-annual valuations of portfolio investments and fund interests must be made in compliance with (conservative) criteria laid down by the Bank of Italy. However, common fund terms require managers to provide investors with quarterly reports including valuations made in accordance with the International Private Equity and Venture Capital Valuation (IPEV) Guidelines issued by the IPEV Board.

Distribution waterfalls almost invariably follow the European ‘fund-as-a-whole’ model with an 8 per cent hurdle rate and a 20 per cent carried interest (with a catch-up mechanism). The greater bargaining power of investors after the financial crisis has resulted in tougher and more protracted negotiations putting certain traditional fund terms under pressure. Escrow and clawback provisions are more frequently negotiated to ensure effective protection against the risk of paying excess carry to the manager or members of its team. Given the small size of most local funds, average management fees continue to be 2 per cent of commitments during the investment period and 2 per cent of invested capital net of write-offs thereafter. However, rebates are frequently negotiated with investors making large commitments, particularly investors joining a fund at first closing. Extensions of a fund’s investment period or term require the consent of a majority in interest of investors (less frequently of the advisory committee), and during such extensions investors normally expect to pay lower fees. The commitment a manager and its affiliates are typically requested to make to a fund is around 2 per cent of total commitments although individual arrangements may vary depending on a number of factors. No-fault remedies sought by investors often include, in addition to the removal of the manager, a right to trigger an early termination of the investment period or an early liquidation of the fund. However, these latter remedies tend to be pushed back by managers in exchange for other concessions. Key manager provisions attract much more attention than in the past, also as a consequence of some breakaways of senior team members of established fund managers in recent years. Triggers are generally becoming stricter and unresolved key manager events are often treated as cause for a removal of the manager (with limited exceptions depending on the nature of
the event and with partially different economic implications). The definition of cause and
the carve-outs in the exculpation and indemnification provisions have become other areas
of more intense negotiation.

Side letters are commonly issued to address investor-specific needs or requests, including
seats on the advisory committee, co-investment opportunities and particular information or
assistance requirements. Most-favoured nation clauses are recurring provisions in side letters.
As the governing rules of a fund prevail over conflicting terms contained in side letters, care
should be taken in determining whether (or subject to what conditions) a particular matter
can be dealt with through a side letter.

iii Key items for disclosure

Fundraising
Fund managers generally prepare a private placement memorandum (PPM) containing
information in line with market practice for delivery to potential investors. A PPM typically
includes information on the manager and its team, an overview of the relevant market, a
description of the manager’s investment strategy, deal flow, sourcing and investment process,
the track record of the manager and senior team members, case studies from the manager’s
track record, a summary of key terms, a description of risk factors and a discussion of the main
legal, regulatory and tax considerations affecting an investment in the fund. It is common
practice for managers also to establish an electronic data room containing more detailed
information on the manager and its investment transactions, legal documentation, updates
and, frequently, responses to a standard due diligence questionnaire (DDQ) designed to
streamline the due diligence process. PPMs and standard DDQs are very often prepared with
the assistance of a placement agent.

Information contained in marketing documents must be accurate, comprehensible and
non-misleading pursuant to applicable regulatory provisions. In addition, certain mandatory
disclosures to potential investors are imposed by Italian and EU law. These include:
a pre-contractual information on the manager, its services, some of its policies, the nature
of the fund interests and connected risks, all costs to be borne by investors in connection
with an investment in the fund and the classification of investors as professional or
retail clients under the provisions implementing the Markets in Financial Instruments
Directive (MiFID);14
b an offering document concerning the fund containing the information set out in
Article 23 of the AIFMD (the offering document); and
c if fund interests are offered to retail investors,15 a short-form document containing key
information on the fund in the format prescribed by Regulations (EU) Nos. 1286/2014
and 2017/653 (key information document (KID)).

Full-scope AIFMs must file the offering document under (b), above, with Consob and obtain
a no-objection letter under the provisions implementing the AIFMD before fund interests
can be marketed (see Section II.iv). If required, the KID is also to be submitted to Consob
before marketing of fund interests (to retail investors) commences. The offering document
and the KID must be kept separate from the PPM and other marketing documents.

14 See footnote 23.
15 Qualifying investors in reserved AIFs include retail investors committing €500,000 or more to the AIF.
Periodic reporting

For each managed fund, the manager must prepare and make available to investors the following documents in the format prescribed by applicable regulatory provisions:

a annual financial statements within six months of the end of any financial year (or of the shorter period in relation to which profits are distributed);

b semi-annual financial statements within two months of the end of any six-month calendar period; and

c a prospectus showing the value of the fund interests as at the end of any calendar semester.

Investments are valued in accordance with criteria set out by the Bank of Italy. The annual financial statements must be audited. Common fund terms generally impose shorter delivery terms for these documents and require managers to provide investors with quarterly reports prepared in accordance with the International Private Equity and Venture Capital Investor Reporting Guidelines issued by the IPEV Board, including a valuation of the portfolio at fair value.

iv Solicitation

Private equity funds are typically marketed by way of private placement, relying on the exemptions from prospectus requirements available under Italian law. Marketing is defined by law as any ‘direct or indirect offering of units or shares of an AIF at the initiative or on behalf of its managing AIFM to investors domiciled or with a registered office in the Union’. No guidance as to what ‘indirect’ means in this definition is provided by regulatory authorities; however, it is sensible to assume that no ‘offering’ is made until the constitutive documents of a fund are in final form and a firm and binding commitment to the fund can be made by an investor. Reverse solicitation is not a legally defined term and no regulatory guidance on this concept is available. As a practical matter, a fund manager should not rely on reverse solicitation unless it has clear evidence that the initial contact with a potential investor in respect of a given fund was made at the initiative of the investor itself. Because offering fund interests in breach of the applicable regulatory provisions is a criminal offence, a manager should act cautiously when relying on reverse solicitation. These concepts will (indirectly) acquire a more precise meaning by effect of recently adopted EU legislation on cross-border distribution of funds, introducing the legal notion of ‘pre-marketing’ and becoming applicable from 2 August 2021.

A full-scope SGR must notify Consob of its intention to market a fund in Italy indicating whether the fund is also expected to be marketed to professional investors in other EU Member States under the AIFMD. The notification must enclose the governing documents of the fund, the offering document and other documentation as indicated in Annex III or IV of the AIFMD, as applicable. Marketing activities can commence after Consob, having verified that the documentation complies with the AIFMD and its implementing provisions, issues a no-objection letter. This process takes some 30 days to complete. Sub-threshold managers are

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16 These exemptions include offerings made to certain qualifying financial intermediaries established by Consob or to a number of potential investors (excluding the intermediaries) not exceeding 150 or to parties investing €100,000 or more.

17 This legislative package includes Directive (EU) 2019/1160 amending the AIFMD and UCITS and Regulation (EU) 2019/1156 amending, inter alia, the EuVECA Regulation.
Italy

not required to go through this process to market their funds in Italy but do not benefit from the AIFMD passport provisions. Managers of EuVECA funds may market their funds in all EU Member States to professional investors and retail investors that commit to investing a minimum of €100,000 under the provisions of the EuVECA Regulation, as amended.

When seeking commitments to a fund, the manager must provide potential investors with the prescribed pre-contractual information, the offering document and (if fund interests are also offered to retail investors) the KID (see Section II.iii). Before accepting subscription agreements the manager must also comply with other requirements, including making appropriateness checks under the MiFID provisions and carrying out customer due diligence procedures under anti-money laundering and counter terrorist legislation. Special regulatory provisions apply when fund interests are offered to retail investors in Italy outside the principal or branch offices of the manager or of a licensed placement agent. These offerings must be carried out acting through licensed tied agents. Also, retail investors must be given the right to withdraw from their subscription agreements without paying any indemnity during a seven-day delay from the date of execution. Any breach of these provisions would make the agreements null and void.

Placement agents are frequently engaged by managers when marketing funds to non-Italian potential investors. Placement agents are instead rarely involved in a purely domestic fundraising.

Under the passport provisions implementing the AIFMD, full-scope EU AIFMs can market their EU AIFs to Italian professional investors and retail investors making a commitment to the fund of €500,000 or more. When transposing the AIFMD into law Italy cancelled its national private placement regime, which was then permitting the marketing of non-Italian AIFs by non-Italian AIFMs to Italian investors subject to an authorisation of the Bank of Italy. As a result, AIFs managed by non-EU AIFMs and non-EU AIFs managed by EU AIFMs may not be currently marketed to Italian investors. This marketing will be permitted when the third-country passport provisions of the AIFMD take effect with the adoption of the relevant delegated acts by the EU Commission (or in the context of the AIFMD review).

v Fiduciary duties

Italian AIFMs (SGRs and internally managed SICAFs) are required by law to act diligently, correctly and in a transparent manner in the best interests of the AIFs they manage, their investors and the integrity of the market. They must also: (1) be organised in a manner that minimises the risk of conflicts of interest and, in the event of a conflict, to ensure the AIFs they manage receive fair treatment; (2) adopt appropriate measures to safeguard the rights of the investors in the AIFs they manage and have adequate resources and adopt appropriate procedures to ensure efficient performance of their services; (3) in the case of reserved AIFs, give preferential treatment to individual investors or categories of investors only in accordance with the AIFMD; and (4) exercise the voting rights attached to financial instruments held by the AIFs they manage in the investors’ interest.
III REGULATORY DEVELOPMENTS

i Regulatory agencies

The Bank of Italy is empowered to issue regulations determining the activities that may be carried out by Italian managers and establishing their legal duties and requirements within the framework of primary legislation applicable to them. Matters covered by Bank of Italy regulation include minimum capital, own funds, risk management, permitted holdings, corporate governance and organisational requirements (including control functions), outsourcing of key functions and services, remuneration and incentive systems and safekeeping of assets. Also, AIFs are subject to the regulatory powers of the Bank of Italy that cover matters such as investment diversification, limitation of risk, format of financial statements, valuation of assets and conditions to satisfy when valuation functions are delegated to an outsourcer. The Bank of Italy authorises Italian entities to carry out collective portfolio management services and keeps the roll where they are registered.

Consob is empowered to issue regulations concerning the duties of transparency and fair business conduct of fund managers in the provision of collective portfolio management services. No objection letters permitting Italian managers to market their AIFs under the provisions implementing the AIFMD are released by Consob. Other regulatory powers of Consob cover matters including inducements, conflicts of interest, personal transactions, complaints handling and knowledge and competence of personnel.

Within their respective remits, the Bank of Italy and Consob have regulatory oversight for Italian managers and AIFs.

ii Authorisation

Authorisation requirements applicable respectively to SGRs and internally managed SICAFs are dealt with in Section II.i in relation to contractual funds and SICAFs. The establishment of reserved AIFs of a contractual nature is not subject to authorisation, registration or any similar requirement; however, their governing rules must be delivered to the Bank of Italy as a reporting requirement. The authorisation requirement applicable to externally managed SICAFs is dealt with in Section II.i in relation to SICAFs.

iii Taxation

Tax exemption at fund level

Italian tax rules consider all AIFs opaque (i.e., non-transparent) entities, regardless of their legal form (i.e., both contractual funds and SICAFs), and treat them as separate taxable persons for Italian purposes. To avoid double taxation, AIFs are fully exempt from income taxes in respect of profits and gains realised in respect of their investments. An exemption applies also in respect of other direct taxes, such as the regional tax on productive activities, although funds established in corporate form (i.e., SICAFs) remain subject to the regional tax on certain management and subscription fees.

No tax ruling is required for this tax regime to apply. Any AIF established in compliance with Italian laws, regardless of whether it is managed in Italy or elsewhere, is considered tax-exempt and is treated as resident in Italy for domestic purposes (as such, it could in theory also avail itself of tax treaties signed by Italy).

The Italian tax authorities have confirmed that, after the implementation in Italy of the AIFMD, AIFs should be subject only to the tax laws of the jurisdiction in which they
are established and that, accordingly, the fact that a non-Italian AIF could be managed by an Italian SGR does not trigger per se the application of Italian tax rules on the AIF itself or on its investors.

**Taxation of investors**

While AIFs are exempt, income taxes in principle apply at the level of their investors. Italian tax rules characterise as 'income from capital' all profits and gains derived from the investment in AIFs. Such income is subject to a withholding tax, which is levied at the standard rate of 26 per cent (although lower rates or exemptions apply in respect of certain investors) in the following cases: distributions, sale or redemption of the fund units or shares, and liquidation of the fund.

The taxable base includes all proceeds effectively distributed to the investors, as well as the balance between the value of the units or shares upon sale or redemption or liquidation of the fund and the subscription or purchase value of the same units or shares. The withholding tax is provisional or final, depending on the nature of the investor. In general, with some exceptions, it is a final levy for all resident investors not acting in a business capacity and for non-resident investors.18

However, the following eligible non-resident investors satisfying specific procedural requirements are entitled to a full exemption from the domestic withholding tax:

- **a** certain international entities established in accordance with international treaties;
- **b** central banks or similar entities;
- **c** investors resident for tax purposes in a whitelisted country (i.e., a jurisdiction that is recognised by a special regulation as having in place with Italy an effective exchange of information for tax purposes); and
- **d** institutional investors established in a whitelisted country (this definition includes entities whose activity consists of investing or managing investments, for their own benefit or on behalf of third parties, regardless of their legal status or tax treatment in the country of establishment).

As a result of the recent international trend of enhanced cooperation between tax authorities, the great majority of foreign jurisdictions have now been included in the Italian whitelist (originally approved by Ministerial Decree of 4 September 1996), which now comprises 134 countries.

In practical terms, most foreign investors are nowadays allowed to rely on the exemption on proceeds of the Italian AIFs in which they invest.

**VAT and other indirect taxes**

Fees charged for management of AIFs and certain related services are exempt from VAT, while fees due for custodian and controlling activities are subject to the standard VAT rate (currently 22 per cent).

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18 A full exemption applies to Italian and foreign investors holding units of Italian (or EU or whitelisted European Economic Area) venture capital funds that invest at least 85 per cent in certain qualifying SMEs (in one of the following phases: seed financing, start-up financing, early stage financing, expansion or scale-up financing), provided that a number of other statutory conditions are met. The definition of eligible venture capital funds and the identification of qualifying SMEs, as well as the other conditions for benefiting from this exemption, have recently been updated in the 2019 Budget Law.
VAT rules in principle apply also to transactions carried out by a SICAF or by an SGR on behalf of contractual funds under management. The investment activities of private equity funds, however, generally fall within the scope of the VAT exemption for financial services (this also entails that input VAT paid in respect of certain services received is not recoverable).

**Stamp duty**

Neither the set-up of AIFs, nor the subscription or sale of their units are subject to any proportional *ad valorem* registration taxes or similar duties.

An annual stamp duty, at the proportional 0.2 per cent rate, may apply to the net asset value of AIFs units or shares, as resulting from their financial statements. This is, in practice, a wealth tax, which applies to all financial investments of certain investors and which is levied by the financial intermediaries involved with holding such investments. For investors other than individuals, this stamp duty is in any case capped at €14,000 per year (although many investors are de facto fully exempt because they do not fall within the subjective scope of application of the stamp duty).

**Carried interest**

Until 2016, there were neither statutory rules nor revenue guidelines specifically dealing with the Italian taxation of carried interest schemes of private equity funds. Careful planning was therefore required to efficiently structure the carried interest for managers of Italian AIFs, having regard to general income tax rules and principles that provided only limited guidance to distinguish between employment-related income (taxable at marginal progressive income tax rates, up to 43 per cent plus surcharges) and investment income (subject to a flat rate of taxation at 26 per cent).

Typically, Italian fund structures set up in past years required an actual financial investment (in most cases ranging between 1 per cent and 3 per cent of the total commitments raised) to be made by the managers in special classes of units or shares of the AIFs that give right to special distributions representing the carried interest entitlement.

In general, the proceeds received by the managers from their investment in these special classes of units of the AIFs were (and still are, subject to certain conditions) characterised as investment income and taxed accordingly. However, the notion of employment-related income laid down by Italian tax rules is very broad, so that the distinction is not always clear-cut and there remains a grey area, where possible concerns could easily arise.

In recent years, the private equity fund industry submitted various proposals to the Italian lawmakers and to the tax authorities to obtain the approval of a special safeguarding rule setting clearly the terms and conditions for the full assimilation of this investment to other financial investments.

After various discussions, in April 2017 the government approved a law decree containing special tax rules for the characterisation and taxation of carried interest, which were subsequently confirmed by the Italian parliament. According to the new provisions (which de facto operate as ‘safe-harbour rules’, as clarified also by the Italian tax authorities) income from direct or indirect participation in companies, entities or investment funds (including AIFs) established in Italy, or in a jurisdiction allowing an adequate exchange of information, arising from shares or other similar financial instruments granting enhanced economic rights (i.e., the carried interest shares or units), will be deemed, by operation of law, as investment income subject to a flat rate of taxation at 26 per cent.
This safe harbour regime applies, as far as AIFs are concerned, provided that all the following conditions are met:

a the carried interest holders collectively invest in the AIF (directly or indirectly) an amount of at least 1 per cent of the total commitments (including also investments in ordinary shares or units);

b the carried interest distributions are subordinated (i.e., they become due only when all the other investors have received a return equal to the invested capital plus hurdle); and

c the special shares or units to which carried interest distributions are attached are held for at least five years.

If one or more of the above conditions cannot be met, the carried interest could still be considered as investment income, subject to a case-by-case analysis and to careful planning and scrutiny. In this respect, the Italian tax authorities have already issued interpretative guidelines (addressing cases where one or more conditions set by the new rules are not satisfied) and have confirmed that they are willing to analyse and provide their view on specific situations if a ruling application is submitted to them.

Special tax incentives available to managers (individuals) relocating to Italy

Managers of private equity funds who plan to relocate to Italy, either for personal reasons or in the context of the establishment of an Italian office of the firm for which they work, can benefit from various tax advantages, which have been extended and made much more appealing, starting from 2017.

The first set of rules that could be of interest for such managers (especially for those moving to Italy to perform a working activity within the country) are those for inpatriate workers. In a nutshell, these rules, as recently modified, starting from fiscal year 2019 for workers who have already moved their fiscal residence in Italy as at 30 April 2019, and who meet the conditions for benefiting from this regime, grant a 70 per cent exemption from personal income taxes, for up to five years (which could be extended for an additional five years if certain conditions are met)\(^\text{19}\) to qualifying new residents in respect of income that they earn from employment or from self-employment activities performed in Italy.\(^\text{20}\)

Other very favourable tax incentives are provided by the new ‘flat-tax regime’, which allows individuals wishing to move their tax residence to Italy to pay an annual flat tax rate of €100,000 in respect of income and gains of any nature (with very limited exceptions) arising from foreign sources (i.e., produced outside Italy);\(^\text{21}\) in practical terms, only income and

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19 This extension is possible to the extent that the inpatriate worker: (1) has at least one child under the age of 18 or who is not economically independent; or (2) has acquired a residential property in Italy, after the relocation, or in the previous 12 months. During the additional five fiscal years, the exemption is limited to 50 per cent of the employment or self-employment income, but this can be increased to 90 per cent in certain cases (e.g., for inpatriate workers with three children under the age of 18 or with any that are not economically independent).

20 The eligible employee or self-employee who moves his or her fiscal residence to Italy may benefit from this special tax regime if he or she: (1) has not been resident in Italy in the two fiscal years prior to the transfer and undertakes to reside in Italy for at least two fiscal years; or (2) performs his or her professional activity mainly in Italy.

21 The benefits of the flat-tax regime may also be extended to other eligible family members by paying an additional €25,000 per year in respect of each additional relative.
gains from Italian sources, if any, remain subject to ordinary income taxes. This regime is therefore very appealing to persons who do not have significant business interests in Italy, or whose working activity or source of income is predominantly based outside Italy; as a matter of fact, a few managers of non-Italian private equity firms have already moved their personal residence to Italy to take advantage of the flat-tax regime, which is available to any individual who has not been fiscally resident in Italy for at least nine of the previous 10 fiscal years. The option of this special regime can be taken year after year, for a maximum of 15 years. A ruling can be obtained by managers interested in assessing whether the flat-tax regime can be applied to them and the specific effects of the regime in respect of their personal situation (e.g., as concerns carried interest structures set up prior to their possible relocation to Italy).

iv Key changes to the regulatory regime

Recent regulatory changes affecting the Italian private equity and venture capital industry include the recast of MiFID (MiFID II), the revision of the EuVECA Regulation and the EU Regulation on key information documents for packaged retail and insurance-based investment products (the PRIIPs Regulation). These regulatory changes originate from EU legislation. Implementing legislation was introduced in Italy in 2017 and subsequent regulatory provisions were published by Consob in 2018 and by the Bank of Italy in 2019.

Under the provisions on product governance implementing MiFID II, Italian fund managers are required to identify the target market and to define the distribution strategy for each fund they plan to establish and market by using five cumulative criteria: (1) the type of client (according to the client categorisation as ‘retail client’, ‘professional client’ or ‘eligible counterparty’, as applicable); (2) the client’s knowledge and experience; (3) the client’s financial situation and ability to bear losses; (4) the risk tolerance and compatibility of the risk or reward profile of the fund with the target market; and (5) the client’s objectives and needs. If the fund is marketed through a distributor subject to the above MiFID II product governance requirements, the fund manager is expected to provide the distributor with reliable and adequate information on the product for the distributor to properly discharge its duties concerning the definition of the target market and distribution strategy for the fund. MiFID II implementing provisions also require fund managers to provide investors with much more detailed pre-contractual information on risks, costs and associated charges.

The 2013 EuVECA Regulation was designed to introduce a simplified regime for establishing funds making qualifying investments in innovative SMEs and for marketing them on an EU-wide basis. As the number of EuVECA funds registered in the first three years following the introduction of this regime was below the expectations, the

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22 Applicants for the flat-tax regime are also fully exempt from (1) Italian wealth taxes on real estate and financial investments held abroad, (2) Italian gift and inheritance taxes on the value of foreign assets and investments, and (3) reporting and filing obligations in relation to the Italian tax authorities in respect of such foreign assets.


26 In accordance with the ESMA Guidelines on MiFID II product governance requirements of 2 June 2017 (ESMA35-43-620).
EuVECA Regulation was amended in 2017 to eliminate some perceived obstacles to a wider diffusion of these funds. Under the amended Regulation – effective since 1 March 2018 – the establishment of EuVECA funds is no longer reserved to sub-threshold managers, as in the previous regime: also authorised full-scope AIFMs are able to establish and market these funds using the EuVECA simplified passport regime. In addition, (1) eligible investments include companies with up to 499 employees (249 in the previous regime) not admitted to trading on a regulated market or on a multilateral trading facility, and SMEs listed on SME growth markets, and (2) EU authorities in the jurisdictions where EuVECA funds are marketed are no longer allowed to impose fees or other charges on EuVECA managers if no supervisory task is to be performed.

Pursuant to the PRIIPs Regulation and its implementing provisions (effective since 3 January 2018), fund managers are required to deliver a KID to retail investors before a fund is marketed to them. The KID is an easy-to-read short-form document (maximum three A4 pages) containing key information on the fund in a prescribed format. Its sections include information on the type of product and its objectives, a summary risk indicator (supplemented by a narrative explanation of the indicator), a performance scenario, whether the investor may face a financial loss because of the default of the manager, the direct and indirect costs associated with an investment in the fund (also presented by means of summary cost indicators), the recommended holding period and the steps to be followed for lodging a complaint. Information about the cumulative effect of costs on return to be provided to investors pursuant to the implementing provisions of MiFID II partly overlaps and should be coordinated with information on costs to be included in the KID.

IV OUTLOOK

The Italian private equity industry is currently facing a transition period. A number of investment teams that raised large funds attracting commitments from primary international limited partners (LPs) in the early part of the 2000s have been unable to consolidate their market position in the subsequent decade – because generational turnover issues were not managed adequately or for other reasons – and have split into smaller teams or just closed down. In a domestic scenario where there continues to be little institutional capital invested in the PE sector, as compared to other countries, established teams now manage smaller funds generally than those of their predecessors (with some exceptions). Also, the global trend towards concentration of capital into a smaller number of top-performing managers (with larger commitments compensating for the increased costs and efforts involved in carrying out deeper due diligence scrutiny) is indirectly raising barriers to the further growth of regional managers falling below the radar screen of most large international LPs.

The local industry is essentially composed of fund managers investing in the various segments of the domestic mid-market. These include several established players managing fund III or IV and having the right profile (track record, deal flow, disciplined investment strategy, team cohesion, size, etc.) to raise funds both in the domestic market and from international investors. Over time, a few of them created multi-jurisdictional teams and structures developing an ability to also invest funds in other European countries (typically, the United Kingdom, France, Germany and Spain). Other notable players in the Italian market are managers of large funds promoted by the public sector and mostly backed by significant capital commitments of Cassa depositi e prestiti, which are active in areas and investment strategies viewed as critical for the national economy (strategic businesses, infrastructures,
turnaround, venture capital, etc.). Recently, unregulated investment schemes pooling capital contributed on a deal-by-deal basis mostly by family offices and high-net-worth individuals have become more popular, and a number of these schemes have been set up.

While this scenario is unlikely to evolve quickly, some legal developments plan to have an impact on the industry in the short term. Tax measures were introduced in recent years (and have been modified several times) to incentivise direct and indirect investments in Italian business entities (and in European Economic Area (EEA) business entities with a permanent establishment in Italy) and to foster innovation. The most important ones are as follows.

a Since 2017, individuals not acting in a business capacity who invest money in certain individual savings plans (PIRs) benefit from a tax exemption on all income and gains deriving from their long-term investment. To this end, at least 70 per cent of the PIR’s assets must be invested in financial instruments (equities or bonds) issued by the above entities, and a proportion of such assets must be in financial instruments issued by entities not included in the main index of the Italian Stock Exchange, Borsa Italiana (FTSE MIB), nor in equivalent indexes of other regulated markets. These requirements may also be met indirectly, by investing in PIR-compliant funds.

b Pursuant to 2019 legislation, a special tax treatment will also be available (from 2020) to resident individuals investing in European long-term investment funds established under Regulation (EU) 2015/760 that invest at least 70 per cent of their commitments in eligible instruments issued by certain Italian-resident companies or EEA companies with an Italian permanent establishment, provided that certain additional conditions and limitations are met.

These tax measures – intended to support the financing of local businesses by individuals – cross with a wider non-tax driven trend involving an ever-increasing offering of fund products tailored to the needs of retail investors seeking exposure to private capital markets (in Italy and abroad), where asset managers and private banks join forces to exploit this new market segment.

Venture capital funds focusing on the domestic market also benefit from tax incentives, based on legislation initially introduced in 2011. Subject to specific statutory conditions, Italian and foreign investors are fully exempt from income taxes in respect of profits and gains deriving from investments in Italian (or EU or whitelisted EEA) venture capital funds that

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27 These include Equity Partners Investment Club, promoted by Mediobanca, and Space Capital Club, which was established in 2019.
28 Up to €30,000 per year and €150,000 over five years.
29 PIRs must hold qualifying investments for at least five years.
30 A similar tax benefit is available to pension funds investing up to 10 per cent of their assets in PIRs or in the equity of Italian companies or EEA companies with a permanent establishment in Italy or in Italian or EEA funds that invest primarily in the equity of such companies (provided that these investments are held for at least five years).
31 This tax treatment provides for a tax exemption on all future profits and gains and an exemption from inheritance tax.
32 Azimut Demos I (€350 million), Fideuram Alternative Investments - Mercati Privati Globali (in partnership with Partners Group – €530 million) and Mediobanca Private Markets Fund I and II (Irish ICAVs managed by Russell Alternative Investments and distributed by Mediobanca – US$250 million) are among the Italian and non-domestic fully paid-in funds investing in private capital markets that were offered in Italy by private banks in 2019.
invest at least 85 per cent of their assets in certain qualifying SMEs in accordance with one of the following strategies: seed financing, start-up financing, early stage financing, expansion or scale-up financing.

Other ongoing and future developments that are expected to affect the industry structure include the following.

In Italy, the categories of permitted investors in a reserved AIF are likely to be modified in the near future. In addition to professional investors (and to directors and employees of the AIFM), these currently include retail investors committing €500,000 or more to the AIF (see Section II.i). The €500,000 threshold has been criticised by the industry as too high, given that non-reserved AIFs are also subject to strict prudential requirements that are not compatible with the features of many AIFs, including private equity and venture capital funds. The Italian regulators are considering different protections for retail investors wishing to invest in reserved AIFs, focusing on the requirement that their admission as investors is based on suitability assessments carried out under MiFID II. It is anticipated that, with the introduction of this requirement, the €500,000 threshold will be eliminated or substantially reduced.

After the recent revision of the EuVECA Regulation,33 Italian managers wishing to market their funds in additional EU jurisdictions begin to consider the registration as EuVECA managers a viable alternative to the AIFMD passport, in light of the relaxed provisions on eligible investments. Indeed, the formal requirements associated with using the EuVECA passport are simpler than those applicable under the AIFMD, and the provisions protecting managers against fees charged by EU authorities in the jurisdictions where EuVECA funds are marketed will be viewed as an additional benefit.

Integrating environmental, social and corporate governance (ESG) considerations in the investment decision-making process is the industry’s new mantra, with an increasing number of Italian institutional investors and fund managers signing the United Nations Principles for Responsible Investment and a growing number of funds being promoted as actively pursuing sustainable investments.34 This trend is expected to be further accelerated by recent ESG legislation and EU initiatives, including Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector, which will become applicable from 10 March 2021.

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33 See Section III.iv.
34 As a recent example, the Italian Association of Insurers launched Fondo Infrastrutture Italia, a private equity infrastructure fund that will be managed by F2i and will select investments in accordance with strict ESG criteria. The fund raised commitments for €320 million at its first closing in February 2020.
Chapter 10

JAPAN

Mikito Ishida

I GENERAL OVERVIEW

The fundraising market for private equity funds in Japan remains strong. Due to the negative interest rate policy that has been present in Japan since 2016, investors such as regional banks are showing a strong appetite for alternative investments that will provide a meaningful level of return on investment. Although there are no official statistics on the fundraising market in Japan, we have noticed increasing demand from various private equity funds in the past year through our fund formation services. With respect to domestic Japanese funds, as at December 2019, the number of private equity members of the Japan Private Equity Association had increased to 43 firms, and there were 96 venture capital members of the Japan Venture Capital Association. Japanese institutional investors have shown stronger interest in global private equity funds as well. Japanese pension funds and universities have shifted, or are willing to shift, a certain portion of their asset allocation to private equity and venture capital firms. Perhaps driven by the same reason, we have seen an increasing demand for funds of funds, which invest in various private equity firms.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Japanese fund vehicles

There are several vehicles available under Japanese law that are used for private equity funds. Each has different characteristics, as explained further below.

Partnership

A partnership is a primitive pass-through vehicle recognised under the Civil Code of Japan. It is often called an NK from the abbreviation of its Japanese name. Both the fund operator and investors will be partners in the NK. As a principal rule, all partners share profits and risks (losses) of the partnership, and all partners bear unlimited liability to third parties. Since investors wish to avoid unexpected losses, investors and the fund operator typically agree in the partnership agreement that the ultimate risk is borne by the fund operator. Nevertheless, a third party that enters into a transaction with the partnership is able to make a claim against the investors for losses, which may not be welcomed by some investors.

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**Investment limited partnerships**

An investment limited partnership (ILP) is a partnership based on a special law (the Act on Investment Limited Partnership Agreements) enacted by the government in 1998 for the purpose of fostering investment funds in Japan. The ILP is based on the Civil Code partnership (NK), with several characteristics added by the special law. The most important characteristic of an ILP is that the investors, which will be limited partners of the ILP, bear limited liability. The liability of a limited partner is limited to the extent of its capital contribution to the ILP. The fund operator will be the general partner and bears unlimited liability to third parties in respect of the liabilities of the ILP. The ILP is the most frequently used fund vehicle in Japan. However, an ILP is prohibited from investing 50 per cent or more of its assets in foreign corporations. Once an ILP is formed, registration is required in the commercial registry within two weeks.

**Limited liability partnerships**

A Japanese limited liability partnership (Japanese LLP) is another variation of partnership based on the Civil Code partnership (NK), where each partner will only bear limited liability in respect of the liabilities of the fund. One important requirement of the Japanese LLP is that all partners must actively participate in the partnership activities, and mere passive cash investment is not permissible. Therefore, a Japanese LLP is not suitable for private equity funds that intend to raise money from various institutional investors. Instead, if there are only to be a limited number of investors, each of which is willing to actively participate in the investment activities of the fund, as may be the case with corporate venture capital, a Japanese LLP is a worthwhile option to consider. A Japanese LLP is also required to make a commercial registration within two weeks of its establishment.

**Silent partnership**

Another choice of fund vehicle is the silent partnership, which is more commonly known by its abbreviation ‘TK’. A TK is recognised under the Commercial Code of Japan, and it is a contractual relationship formed by an agreement between the TK operator and the TK investor. In a TK, the TK investor makes a contribution to certain business of the TK operator (TK business), and the TK operator distributes profits arising from the TK business to the TK investor. The money contributed by the TK investor belongs to the TK operator, and all activities of the TK business are conducted by the TK operator in its own name (and not in the name of the fund). The TK investor does not hold any direct interest in the assets comprising the TK business, and the liability of TK investor is limited to the extent of its contribution. There are no registration requirements when forming a TK.

Tax treatment of a TK differs from other pass-through partnerships, especially if the investor is an individual. A TK is often used together with a Japanese limited liability company (LLC), which will be the TK operator.
ii Characteristics of Japanese fund contracts

Model agreement form

Japanese fund contracts generally follow the structure of global fund contracts in many respects, such as the management fee and carried interest structure. However, some of the terms and conditions widely accepted in Japanese fund contracts differ from globally recognised terms. The reason for this is because most Japanese ILP fund contracts are based on the model agreement form provided by the Ministry of Economy, Trade and Industry (METI), and some of the content of the model agreement form is not totally aligned with that currently considered to be global standard, especially compared with the terms and conditions of complicated fund agreements adopted in global private equity funds.3

Organization for Small & Medium Enterprises and Regional Innovation requirements

Another characteristic of Japanese ILP fund contracts is that many agreements contain specific terms related to the Organization for Small & Medium Enterprises and Regional Innovation (SMRJ). The SMRJ is a government-related administrative agency that invests in private equity funds, and a large number of Japanese funds are currently being invested in by the SMRJ (as a limited partner). The SMRJ requires that the funds into which it invests must have certain terms stipulated in its investment rules, such as a requirement that a certain portion of the fund’s portfolio investments are made in small and medium-sized enterprises.

iii Overview of fundraising regulatory framework

Prior to the introduction of the Financial Instruments and Exchange Act of Japan (FIEA) in 2007, partnership interests were not considered to be ‘securities’ under the securities laws in Japan, and there were very limited restrictions on fundraising by partnerships. However, an interest in a fund is now categorised as a security under the FIEA, and is subject to its regulation. The Japanese regulations on private equity funds differ depending on the fund structure (i.e., whether it is a partnership-type fund or a corporation-type fund).

iv Regulations on partnership-type funds

Partnership-type funds are the main vehicle used for fund formation in Japan. Partnership interests are recognised as being interests in a collective investment scheme,4 which fall within the securities enumerated in the FIEA. Therefore, a partnership involving Japanese investors, regardless of whether its general partner is located outside Japan and the limited partnership is established outside Japan, is subject to regulation under the FIEA in that the general partner may be required to register or to file a notification, as the case may be, with the Financial Services Agency (FSA), the relevant Japanese regulatory authority, both in respect of (1) its offering activities in Japan or to Japan-resident investors (the Offering Regulations) and (2) its investment management activities for a fund involving Japanese investors (the Investment Management Regulations).

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2 Since ILPs are the most frequently used vehicle for Japan-based private equity funds, this section focuses on the terms of ILP contracts.
3 The latest version of the model agreement form published in 2018 is only available in Japanese, although the previous version of the model agreement form published in 2010 has an English translation.
4 See Article 2(2)(v) and 2(2)(vi) of the FIEA for a further definition of collective investment schemes.
The Offering Regulations and the Investment Management Regulations are generally structured under the concept that the offering activities and investment management activities are conducted by the general partner of the fund, rather than by the manager of the fund. Therefore, registration or filing required under the Offering Regulations or the Investment Management Regulations is typically required to be made by the general partner of the private equity fund.

**Offering Regulations**

Under the Offering Regulations, in principle, to solicit partnership interests of a private equity fund in Japan, the general partner of the fund must register with the FSA as a Type II financial instruments business operator. However, registration as a Type II financial instruments business operator is a document-intensive and time-consuming process and generally requires several months of preparation. Therefore, a majority of fund operators typically utilise the Article 63 exemption (see below), which is one of the exemptions set out in the FIEA. With respect to foreign private equity funds, some fund operators may instead retain a Japanese firm that is already registered as a Type II financial instruments business operator (such as a securities firms) for the purpose of marketing the fund in Japan.

**Investment Management Regulations**

The Investment Management Regulations have the same structure as the Offering Regulations in that they generally require registration but have certain exemptions. In principle, a general partner that manages a fund that has a Japanese investor must register with the FSA as an investment management business operator. However, registration as an investment management business operator is likely to be even more time-consuming than registration as a Type II financial instruments business operator, and, hence, foreign private equity funds normally also seek to rely on exemptions from such registration.

**Article 63 exemption**

One of the frequently used exemptions from the registration requirement under the Offering Regulations and the Investment Management Regulations is called the Exemption for Special Business Activities for Qualified Institutional Investors, stipulated in Article 63 of the FIEA (the Article 63 exemption). A fund operator using this exemption is known as an Article 63 exempted operator. If the general partner can rely on this exemption, it can conduct offering activities in Japan and investment management activities for Japanese investors by filing a notification called a ‘Form 20’ with the FSA. Documents required for the Article 63 exemption can be prepared in English.

In a high-level summary, the Article 63 exemption requires that:

- **a** at least one of the fund investors is a qualified institutional investor (QII);
- **b** the number of Japanese non-QII fund investors is no more than 49;
- **c** each Japanese non-QII fund investor is an eligible non-QII;
- **d** the Japanese investors do not include investors that are considered to be disqualifying investors, such as certain types of collective investment schemes;
- **e** the general partner submits a copy of its constitutional document;
- **f** officers and certain employees of the general partner submit to the FSA their CV and certification of their compliance with the qualification requirements prescribed in the FIEA;
- **g** the partnership interests are subject to certain transfer restrictions; and
if the general partner resides outside Japan, a representative in Japan (who will be in charge of communication with the FSA) is appointed by the general partner.

However, even if the above exemption applies, the general partner is still required to comply with certain ongoing obligations under the FIEA, including the following:

a. submitting a business report together with its balance sheet (and profit and loss statements in some cases) to the FSA within three months of the end of each fiscal year;

b. making certain excerpts from the Form 20 and the business report available to the public; and

c. filing an amended Form 20 or submitting a copy of an amended constitutional document when any revision is made to the contents.

In addition, Article 63 exempted operators are subject to supervision and enforcement by the FSA, including reporting requirements, on-site inspections and business improvement orders or business suspension orders.

The Article 63 exemption has a fund-of-funds regulation that includes a look-through rule, and investors of upper-tier funds must also be counted against the threshold of 49 non-QII investors. Moreover, certain types of fund vehicles are prohibited from investing in a fund using the Article 63 exemption.

The entire list of Article 63 exempted operators is publicly available on the FSA’s website.

QII

The QII is the key concept that needs to be considered in checking the applicability of the Article 63 exemption. Unless there is a Japanese investor that qualifies as a QII, it is difficult for the general partner of a private equity fund to be exempted from the registration requirement by utilising the Article 63 exemption. Various types of institutions that fall within the definition of a QII are prescribed in a cabinet office order under the FIEA. For example, Japanese banks and insurance companies are enumerated as QIIIs. Companies and individuals that hold investment assets (securities) of no less than ¥1 billion can become QIIIs through a filing with the FSA. Such filing must be renewed biennially. The list of QIIIs is available on the FSA’s website, so private equity funds can access the website and check whether the targeted Japanese investor is a QII or not. QIIIs are considered to be professional investors under the FIEA and, therefore, some of the regulations are mitigated for financial transactions with QIIIs.

Transfer restrictions

Another important concept of the Article 63 exemption is transfer restrictions. Transfer restrictions should be included in the partnership agreement or other executed documents to qualify for the Article 63 exemption from the Offering Regulations. The transfer restrictions should stipulate that QII investors may only transfer their partnership interests to other QIIIs, and non-QII investors may only transfer their entire interest to a single investor that is a QII or an eligible non-QII.
**De minimis Japanese QII exemption**

If a non-Japanese private equity fund is marketing to Japanese investors, another exemption available is the *de minimis* Japanese QII exemption. If the requirements for this exemption are met, the general partner is exempted from both registration and filing of a notification with respect to the Investment Management Regulations.

The *de minimis* Japanese QII exemption requires that:

a. the non-Japanese fund has fewer than 10 Japanese fund investors, whether directly or indirectly through a Japanese collective investment scheme;

b. all Japanese direct and indirect fund investors are QIIs; and

c. the aggregate capital contributions to the fund by such Japanese fund investors represent no greater than one-third of the aggregate capital contributions of all fund investors.

However, this exemption only applies to the Investment Management Regulations, and not to the Offering Regulations. Therefore, the general partner of a foreign private equity fund still needs to file Form 20 in respect of offering activities, unless all marketing activities in Japan for such fund are carried out by a registered placement agent (Type II financial instruments business operator) under the FIEA. A general partner may use the Article 63 exemption for the Offering Regulations and thereafter rely on the *de minimis* Japanese QII exemption for the Investment Management Regulations.

**v Solicitation of non-Japanese corporation-type fund**

In the case of a non-Japanese corporation-type fund, the solicitation of shares of such fund is typically delegated to and handled by a registered placement agent (Type I financial instruments business operator, such as a securities firm in Japan), and the fund itself does not conduct any marketing or offering to Japanese investors.

An investment fund established in the form of a company or a trust will likely be interpreted as a foreign investment corporation or foreign investment trust within the meaning of the Act on Investment Trusts and Investment Corporations (AITIC). Pursuant to the AITIC, prior to offering such company’s shares in Japan, the issuer must file a notification with the FSA. The filing must be made in Japanese. Under the AITIC, the notification must contain information including details on the management and investments of the fund, the calculation of the net asset value of the fund and the distribution of profits.

The AITIC does not require that investment management reports be prepared or delivered to shareholders of foreign investment corporations (as opposed to foreign investment trusts).

**vi Public offering**

The information above generally assumes that the offering of interests in the fund qualifies as a private placement under the FIEA. However, if more than 499 limited partners subscribe for a partnership-type fund in Japan, for example, it will be subject to public offering disclosure regulations, and registration statements and other disclosure documents will be necessary for the offering of such fund.
vii Anti-Money Laundering Law

Pursuant to the Act on Prevention of Transfer of Criminal Proceeds, an Article 63 exempted operator must obtain certain documents prior to, or at the execution of, the subscription agreement of the fund with each Japanese investor for anti-money laundering purposes. In particular, there is certain information that must be obtained for purposes of investor identification. The Act also requires identification of the representative executing the fund subscription and identification of the ‘effectively controlling person’ of the investor. Furthermore, if a transaction is considered a high-risk transaction as stipulated in the Act (e.g., a transaction with certain foreign politically exposed persons), additional scrutiny of the identification of the investor will be required, and transactions having a suspicion of money laundering should be reported to the government authority. In addition, the Act requires record keeping with respect to investor identification procedures and transactions with investors.

viii Act on Sales of Financial Products

In accordance with the Act on Sales of Financial Products, a fund operator that conducts the business of selling financial products in Japan or to Japanese investors must explain certain important matters to investors prior to the sale of financial products. However, the fund operator does not need to provide such explanation to certain professional investors defined under the Act (which includes QIIs), and the fund operator may also obtain consent from its investors that it does not need such explanation on certain important matters.

III REGULATORY DEVELOPMENTS

Reform of Article 63 exemption

In 2016, there was a major reform of fund regulations under the FIEA. After the amendment, requirements to qualify as an Article 63 exempted operator increased significantly. The following are the major new requirements.

Limitation of investors to eligible non-QIIs

Prior to the amendment of the FIEA in 2016, there were no required criteria for Japanese investors that were not QIIs. However, under the amended FIEA, for a fund operator to qualify for the Article 63 exemption, all of the Japanese fund investors need to fulfil certain minimum economic criteria or qualify as a person that is closely related to the fund, as enumerated in the FIEA (eligible non-QII). As a result, it became difficult for private equity funds to solicit individual investors other than those that are sufficiently wealthy to meet such criteria. The status of an eligible non-QII will be determined at the time of solicitation, and this status does not need to be maintained during the entire term of the fund.

Appointment of a representative in Japan

Another new requirement specifically for non-Japanese funds is the appointment of a representative. If an Article 63 exempted operator does not reside in Japan, it must appoint a representative in Japan. This representative needs to be a resident in Japan and can either be a natural person or a corporation. The representative should function as a contact person for communication with the FSA (or the Kanto Finance Local Bureau, which is, in practice, the contact point of the regulators).
Additional investor disqualification

Under the amended FIEA, an Article 63 exemption will not be available if either of the following criteria applies to the relevant fund during its term:

a  the only QII in the fund is an ILP, and such ILP has net assets under management of less than ¥500 million; or

b  50 per cent or more of the fund assets contributed by all investors are contributed by investors with a close relationship with the Article 63 exempted operator (as further specified in the FIEA).

Additional documents for Form 20 filing

As a result of the FIEA amendment, an Article 63 exempted operator is required to submit its articles of incorporation (or other constitutional documents, such as an operating agreement of an LLC) and a statement letter that indicates that the Article 63 exempted operator is not disqualified from the Article 63 exemption as prescribed in the FIEA. In addition, officers and certain employees of the Article 63 exempted operator must submit an affidavit of certain personal information (e.g., name, address and date of birth), their CV and a statement letter certifying their compliance with the qualification requirements as prescribed in the FIEA.

Public disclosure by the Article 63 exempted operator or FSA

Public disclosure requirement has also been strengthened by the 2016 amendment. Without delay after filing Form 20, an Article 63 exempted operator must make publicly available certain information excerpted from Form 20 on its website or by other methods that can be accessed easily by the public. The form of this disclosure is called Form 20-2 and is available on the FSA website.

The FSA will also disclose the contents of Form 20-2 to the public on its website, with respect to all Article 63 exempted operators.

Annual business report and disclosure booklet

Under the amended FIEA, Article 63 exempted operators must submit a business report (Form 21-2) for each fiscal year within three months of the end of such fiscal year. If the investors are limited to professional investors, certain information, such as composition of fund assets, may be omitted from the business report.

The Article 63 exempted operator must make publicly available a disclosure booklet (Form 21-3, which is an excerpt of the business report) at its office in Japan, on its website, or by other means, for a period of one year, commencing four months after the end of the relevant fiscal year.

Stricter compliance regulations

Prior to the amendment of the FIEA in 2016, Article 63 exempted operators were only subject to a limited number of compliance regulations, such as prohibition of making false statements and compensating losses incurred by investors. However, since 2016, Article 63 exempted operators have been subject to many compliance regulations that were historically applicable to registered financial instruments business operators only, including the following:
delivering a notice to each professional investor stating that it has the option to change its status from a professional investor to a non-professional investor;

delivering certain explanatory documents explaining certain important risks of the fund, which should be delivered twice (prior to the subscription and at the time of subscription) to the investors that are non-professional investors;

delivering an investment management report to non-professional investors periodically;

keeping certain records of financial transactions, such as limited partnership agreements, subscription agreements and investment management reports, for a maximum period of 10 years;

including provisions in the partnership or subscription agreement requiring the segregation of fund assets from the proprietary assets of the Article 63 exempted operator;

notifying the FSA if the Article 63 exempted operator becomes subject to a lawsuit, or if a director or employee of the Article 63 exempted operator violates the law in respect of the relevant fund business;

advertising by an Article 63 exempted operator must fulfil certain requirements, including a description of fees it charges; and

complying with the duties of good faith and fairness, loyalty and care of a good manager.

IV OUTLOOK

The number of private equity funds and venture capital funds in Japan has increased significantly in recent years. Reflecting this growth, as well as the variation and diversified use of fund vehicles, the regulators have continually tightened the regulations on private equity funds in Japan. We anticipate that restrictions on fund solicitation and fund management will likely further increase.

Another noteworthy trend is that Japanese financial institutions are starting to further scrutinise and monitor the internal compliance rules of private equity funds. This is partly because the bank leverage regulations now require Japanese financial institutions to check the investment policy of the private equity funds in which they invest, to lower the multiples applicable in the calculation of its risk-weighted assets.

5 ‘Professional investor’ is defined in the FIEA. Examples of professional investors are: QIIs, listed companies, Japanese corporations whose capital is reasonably expected to be no less than ¥500 million and foreign legal entities.
Chapter 11

LUXEMBOURG

Frank Mausen, Peter Myners, Patrick Mischo and Jean-Christian Six

I GENERAL OVERVIEW

The Luxembourg asset management industry had another stellar year in 2019. We have seen a massive increase in the number of large private equity managers that have chosen Luxembourg as their European domicile of choice for the establishment of their funds and their alternative investment fund manager (AIFM). Some of the largest private equity firms worldwide have now chosen Luxembourg as their main European hub.

Several factors are contributing to the growth of the Luxembourg private equity industry. One of them is certainly the wide range of Luxembourg vehicles that are appropriate for structuring private equity funds. Most private equity funds that have been established in Luxembourg since 2013 have been established as unregulated vehicles, either as unregulated Luxembourg limited partnerships (LPs) or more recently as reserved alternative investment funds (RAIFs). Between December 2018 and January 2020, the number of RAIFs increased from 561 to 925.

Another factor is the convergence of regulatory and tax developments, in particular the Alternative Investment Fund Managers Directive (AIFMD) and the Organisation for Economic Co-operation and Development (OECD) action plan against base erosion and profit shifting (the BEPS Action Plan), which all point in the direction of an increased focus on the operational presence of the manager in the country where the funds and their special purpose vehicles are located.

II LEGAL FRAMEWORK FOR FUNDRAISING

Over the years, Luxembourg has developed an amazing toolbox of structuring solutions. Key milestones in that process are as follows:

1. March 2004: creation of securitisation undertakings;
2. June 2004: adoption of the investment company in risk capital (SICAR), a regulated vehicle specifically designed for investments into private equity;
3. 2007: adoption of the specialised investment fund (SIF), a regulated vehicle appropriate for the structuring of any type of alternative investment fund (AIF), including private equity funds;
4. 2013: overhaul of the Luxembourg LP regime, with a modernisation of the rules applicable to the common limited partnership (SCS) and the creation of the special limited partnership (SCSp); and

1 Frank Mausen, Peter Myners, Patrick Mischo and Jean-Christian Six are partners at Allen & Overy.
2016: creation of the RAIF, a vehicle that is not subject to the direct supervision of the Luxembourg supervisory authority (CSSF) and may be used for the structuring of any type of AIF, including private equity funds.

Unregulated LPs

Since 2013, the LP (in the form of an SCS or SCSp) has become the vehicle of choice for the structuring of Luxembourg funds investing in illiquid assets, including private equity. The Luxembourg LP regime offers wide structuring flexibility and enables sponsors to tailor the fund structure to fit their specific needs.

The main difference between SCSs and SCSp is that SCSp have no legal personality of their own, in contrast to SCSs, which do. The SCSp is, therefore, similar to an English LP, while the SCS is closer to a Scottish LP or a German KG. From a Luxembourg (legal and tax) standpoint (and for an AIFMD-compliant vehicle), the choice between an SCS and an SCSp has no material impact on how the Luxembourg LP will operate and interact with its partners and counterparties (and does not impact at all on the responsibility of investors, who benefit from limited liability in both structures). This choice is generally driven by investors’ preferences. Anglo-American sponsors and investors are generally more familiar with the SCSp structure, which is closer to an English LP.

The SCS and the SCSp are two types of Luxembourg companies. LPs, therefore, do not have a regulatory status, and Luxembourg LPs (SCSs and SCSp) may, therefore, be established either under one of the specific product regimes available (SICAR, SIF or RAIF regimes) or outside those regimes (in which case they are generally referred to as ‘unregulated LPs’).

The key features of unregulated LPs are very similar to those of English, Scottish or US LPs. This enables Anglo-American sponsors to establish their Luxembourg funds in a format that they, and their investors, are familiar with. They use their standard documentation for the launching of their Luxembourg LP, with limited adjustments only. The unregulated LP may be used for the structuring of funds, feeder funds, parallel funds, co-investment vehicles or carried interest vehicles.

More and more private equity managers are establishing parallel fund structures with two separate funds, one in Luxembourg targeting European investors and the other in another jurisdiction, targeting US investors, for instance. The unregulated LP regime offers the flexibility needed to ensure that the Luxembourg fund operates on the basis of the same principles as those that apply to the parallel fund.

Luxembourg LPs benefit from a number of attractive features that may not be available in all other jurisdictions. For instance, in certain jurisdictions, capital returned to limited partners is subject to a risk of clawback in certain circumstances. To limit that risk, limited partners’ commitments are structured by way of a combination of a small amount of capital (exposed to the clawback risk) together with a large percentage of a non-interest-bearing loan. In a Luxembourg LP, capital returned to partners by way of distribution of dividends or reimbursement of partnership interests cannot be recalled, unless otherwise provided for in the partnership agreement. Investor commitments in a Luxembourg LP may, therefore, be structured by way of a 100 per cent capital contribution.

As is the case in most jurisdictions with an LP regime, limited partners in a Luxembourg LP may lose their limited liability if they intervene in the management of the LP. However, in Luxembourg this risk only arises if a limited partner carries out acts of external management, which entail an element of representation of the LP towards third parties. The Luxembourg LP regime provides expressly that limited partners are not at risk of losing the benefit of
their limited liability if they perform acts that are internal to the LP, such as exercising rights attached to the status of a partner in the LP, providing advice or consultation or controlling the business of the LP.

Unregulated LPs are not subject to the supervision of the CSSF. An unregulated LP may, therefore, be launched without the approval of the CSSF and no regulatory approval is required in relation to any of the steps to be performed during the life of the unregulated LP.

However, this does not mean that all unregulated LPs fall outside regulatory supervision. Unless they benefit from an AIFMD exemption (such as the de minimis exemption for smaller funds or the exemption for AIFs managed by a non-EU manager), unregulated LPs that are AIFs must be managed by an authorised AIFM and are, therefore, indirectly subject to regulatory oversight through their AIFM. This also means that, despite the absence of direct regulatory supervision, an unregulated LP that is managed by an authorised AIFM (whether in Luxembourg or in another EU Member State) fully benefits from the AIFMD marketing passport.

The new Luxembourg LP regime is extremely successful. However, the unregulated LP may not be the most suitable vehicle in all circumstances:

First, unregulated SCSs and SCSpS cannot avail themselves of the umbrella structure, and so cannot create segregated portfolios of assets and liabilities (compartments).

Second, SCSs and SCSpS are not subject to taxation (provided they can be regarded as AIFs or meet certain conditions that have been clarified by the Luxembourg tax authorities by way of Circular LIR No. 14/4 dated 9 January 2015) and a tax-opaque vehicle (with access to certain double taxation treaties) may be more appropriate in certain circumstances.

Finally, LPs may in certain circumstances qualify as a hybrid entity because of their tax transparency under the European anti-hybrid rules, triggering unfavourable tax consequences. In that respect, the RAIF offers a wider range of legal and corporate forms to meet tax needs while remaining unregulated. In particular, the corporate governance characteristics of the partnership limited by shares (SCA) are very similar to those of the SCS and SCSp, with the main difference being that the SCA is a tax-opaque company. Similarly to the SCS and the SCSp, an SCA is managed by a manager or general partner, and its limited partners may participate in advisory or supervisory boards without being deprived of their limited liability.

ii RAIFs

The RAIF regime offers a solution to managers who want to avoid a double layer of regulation when setting up AIFs, while at the same time benefiting from the umbrella structure that, until the adoption of the RAIF, was reserved for regulated funds such as SIFs and SICARs. Also, RAIFs may be established either as tax-transparent or tax-opaque vehicles.

The RAIF is reserved for the structuring of funds that appoint a duly authorised AIFM, established in Luxembourg or in any other EU Member State.

RAIFs may be established under different legal forms, including that of a common fund or an investment company incorporated, among other corporate forms, as a public company, an SCA or an SCSp.

RAIFs must in principle comply with the risk-spreading principle, with a maximum concentration ratio in any single investment of 30 per cent. However, RAIFs that have the sole objective of investing in risk capital may be exempted from the risk diversification requirement and benefit from a tax regime that is similar to that applicable to SICARs. The concept of risk capital covers basically all types of private equity and venture capital strategies.
iii Securitisation undertakings

An additional and increasingly popular funding method in Luxembourg is securitisation, by which a Luxembourg securitisation undertaking acquires or purchases risks relating to certain claims, assets or obligations assumed by third parties, and finances the acquisition or purchase by the issue of securities, the return on which is linked to these risks.

Despite certain image problems of securitisation in general after the sub-prime crisis in 2007–2008, there has been a very positive development and steady growth of the Luxembourg securitisation market in the past couple of years. At the beginning of 2020, over 1,400 securitisation vehicles had been registered with the Luxembourg trade and companies register. Furthermore, this number does not accurately reflect the success of the Luxembourg securitisation market as Luxembourg law allows, as further described below, for securitisation vehicles to create several compartments. It has become the funding method of choice for more and more companies that own suitable financial assets.

The Luxembourg Securitisation Act of 22 March 2004, as amended (the Securitisation Act 2004) provides a complete and solid legal framework for the Luxembourg securitisation market and is considered as one of the most favourable and advanced pieces of European legislation for securitisation and structured finance transactions. The robustness and flexibility of this Act is highly appreciated by the international participants using Luxembourg as a hub to set up securitisation undertakings governed by Luxembourg law to access the capital markets.

The Securitisation Act 2004 distinguishes between regulated and unregulated securitisation undertakings. A securitisation undertaking must be authorised by the CSSF and must obtain a licence if it issues securities to the public on a continuous basis. Both regulated and unregulated securitisation undertakings benefit from all the provisions of the Securitisation Act 2004. A securitisation undertaking must mainly be financed by the issue of instruments (be it equity or debt securities) that qualify as securities under their governing law. The Securitisation Act also distinguishes between securitisation companies and securitisation funds that consist of one or more co-ownerships. Until now, the vast majority of securitisation undertakings adopted a corporate form. However, in light of the implementation into Luxembourg tax law of the new interest limitation rule, in accordance with the EU Anti-Tax Avoidance Directive (ATAD 1),2 securitisation funds, which are not corporate income taxpayers, have gained in popularity. Securitisation undertakings may also issue securities in a fiduciary capacity, which is also a useful tool in the context of ATAD 1.

The Securitisation Act 2004 contains no restrictions regarding the claims, assets or obligations that may be securitised. Securitisable assets may relate to domestic or foreign, movable or immovable, future or present, tangible or intangible claims, assets or obligations. It is also accepted that a securitisation undertaking may, under certain conditions, grant loans directly. Very advantageous provisions for the securitisation of claims have been included in the Securitisation Act 2004.

To enable the securitisation of undrawn loans or loans granted by the securitisation undertaking itself, the Luxembourg Act dated 5 April 1993 relating to the financial sector, as amended, exempts these transactions from a banking licence requirement. Furthermore, transactions that fall within the scope of the application of the Securitisation Act 2004 (such as, for example, credit default swaps) do not constitute insurance activities that are subject to Luxembourg insurance legislation.

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2 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
The Securitisation Act 2004 allows the board of directors of a securitisation company or the management company of a securitisation fund to set up separate ring-fenced compartments. Each compartment forms an independent, separate and distinct part of a securitisation company’s estate, or a distinct co-ownership of a securitisation fund, and is segregated from all other compartments of the securitisation undertaking. Investors, irrespective of whether they hold equity or debt securities, will only have recourse to the assets within the compartment to which the securities they hold have been allocated. They have no recourse against the assets making up other compartments. In the relationship between the investors, each compartment is treated as a separate entity (unless otherwise provided for in the relevant issue documentation). The compartment structure is one of the most attractive features of the Securitisation Act 2004, as it allows the use of the same issuance vehicle for numerous transactions without the investors running the risk of being materially adversely affected by other transactions carried out by the securitisation undertaking. The feature allows securitisation transactions to be structured in a very cost-efficient way without burdensome administrative hurdles. It is important to note that there is no risk-spreading requirement for compartments. It is hence possible to isolate each asset held by the securitisation undertaking in a separate compartment.

The Securitisation Act 2004 also expressly recognises the validity of limited recourse, subordination, non-seizure and non-petition provisions. Rating agencies are very comfortable with transactions structured under the Securitisation Act 2004 as legal counsel can usually issue clean legal opinions.

The Luxembourg legislature has clearly succeeded in transforming Luxembourg into one of the leading financial hubs for securitisation and structured finance vehicles by producing an attractive legal and tax framework for Luxembourg securitisation vehicles.

III TAX AND REGULATORY DEVELOPMENTS

In August 2018, the CSSF released Circular 18/698 on Luxembourg investment fund managers, which provides helpful guidance on the ‘substance’ and organisational requirements for approval as an AIFM in Luxembourg. Existing AIFMs had until the end of 2019 to adapt to the new rules.

The choice of a vehicle for the structuring of Luxembourg funds may, in the near future, become increasingly driven by tax considerations, in particular in light of the recent implementation (i.e., on 20 December 2019) into Luxembourg tax law of the second EU Anti-Tax Avoidance Directive3 (the ATAD 2 Law).

The ATAD 2 Law contains a set of anti-hybrid rules that draw inspiration from the OECD BEPS Action Plan. The objective of these rules is to neutralise the tax effects of hybrid mismatches arising from different characterisations of a financial instrument or an entity under the laws of two Member States, or of one Member State and a third country. Indeed, the different characterisations of a financial instrument or an entity may, in particular, give rise to a situation of ‘deduction without inclusion’, meaning that payments under the hybrid instrument or to the hybrid entity may be deductible in the country of the payor but may

not give rise to an inclusion in the tax base in the country of the payee, nor in any other jurisdiction, with the consequence that the deduction may, under the future anti-hybrid rules, be denied in the country of the payor.

In the context of Luxembourg funds, a tax-transparent LP may, in a private equity context, be considered tax-opaque by its investors (for instance, under the US check-the-box rules or in accordance with the investors’ domestic rules regarding the classification of foreign entities for tax purposes) and thus fall within the definition of a hybrid entity under the ATAD 2 Law. The hybridity of the entity is, as such, not sufficient for the rule to apply. Checks would have to be made as to whether the hybridity gives rise to a negative tax effect, such as a situation in which deduction occurs without inclusion of payments made by a Luxembourg company held by the LP to the limited partners, or a situation of double deduction. Similarly, different characterisations of a financial instrument granted by a Luxembourg LP to an underlying Luxembourg company may, in a private equity context, give rise to negative tax effects, whereby the deductibility of the interest under the financial instrument could be denied at the level of the Luxembourg company held by a Luxembourg LP.

These rules will only apply between related or associated parties or in the context of a structured arrangement. An investor might be considered an associated entity in relation to the underlying Luxembourg company, in particular if it holds through the LP a direct or indirect interest of at least 50 per cent or more of the Luxembourg company. For the anti-hybrid rule on financial instruments to apply, the required threshold is reduced to 25 per cent.

Finally, the ATAD 2 Law also sets out a ‘reverse hybrid mismatches’ rule, which will only apply as from 1 January 2022. This rule targets the hybrid entity as such, and not the deductibility of interest paid by a Luxembourg company to the entity. The rule provides that an EU resident entity (which is treated as being tax-transparent in its country of residence but as tax-opaque in the country of its non-resident direct or indirect owners) will have to be treated as being tax-opaque and subject to tax in its country of residence as a result of its hybridity. For this rule to apply, non-resident investors considering the entity as tax opaque would have to hold at least 50 per cent of the entity’s interest. The ATAD 2 Law sets out a specific carve-out from this rule for collective investment vehicles, and alternative investment funds may also benefit from the carve-out under certain conditions.

Asset managers should carefully consider the impact of the ATAD 2 Law on their existing and future fund structures.

IV OUTLOOK

Brexit is likely to be one of the main challenges for the European private equity industry over the next few years. The United Kingdom left the European Union on 31 January 2020 with a transition period lasting until 31 December 2020. During this period, most EU rules will continue to apply to the United Kingdom and negotiations in relation to a trade agreement will take place. The transition period may, before 1 July 2020, be extended once, by up to two years. After the transition period, all UK fund managers will lose the benefits of EU passports, which currently allow them to manage and market their funds on a cross-border basis within the European Union. The counter-attack generally consists of establishing a regulated manager in another EU Member State. This entails building up sufficient substance locally and, in particular, recruiting suitable personnel. When comparing the solutions available in various EU jurisdictions, numerous criteria, such as the existence of a stable and
robust regulatory and tax framework, must be taken into account; Luxembourg’s status as the leading European fund domicile is a strong argument in its favour. Concentrating funds and their managers in one and the same jurisdiction offers many benefits: the same legal and regulatory framework, and the ability for funds and their managers to share local resources, etc. It is, therefore, no surprise that several leading private equity firms have decided to establish their European hub in Luxembourg.
Chapter 12

MEXICO

Hans P Goebel C, Héctor Arangua L, Adalberto Valadez and Miguel A González J

I GENERAL OVERVIEW

Over the past 19 years, Mexico’s private equity (PE) industry has raised over US$58 billion in capital commitments to PE investments, according to the Mexican Private Equity Association (AMEXCAP). Mexico’s strong industrial and manufacturing sectors, along with recent reforms to policies and regulations, have had a positive impact on the PE industry, resulting in double-digit annual growth for the industry. Real estate and venture capital (VC) also had double-digit increases in the same period, of 16 per cent and 12 per cent, respectively. Currently, the number of active fund managers is over 180, with fund managers, or general partners (GPs), active across a range of sectors, and representing a sevenfold growth since the beginnings of the industry in the early 2000s.

According to the Secretariat of Economy of Mexico, Mexico is one of the world’s most globalised countries, with 12 free trade agreements spanning 46 countries; nine partial-scope and economic complementation agreements within the framework of the Latin-American Integration Association; membership of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP); and 32 reciprocal promotion and protection-of-investments agreements, with 33 countries. Mexico’s diversified export line is ranked 15th in the world and it is the fourth-largest car manufacturer in the world, with the third-largest growth in exports within the automotive industry. Mexico actively participates in multilateral and regional organisations and forums, such as the World Trade Organization, the Asia-Pacific Economic Cooperation, the Organisation for Economic Co-operation and Development and the CPTPP.

In recent years, the Mexican government has been an important participant in and supporter of the PE industry, investing in more than 72 funds through institutional investors such as NAFIN (the national development bank), the Capitalization and Investment Fund for the Rural Sector, Bancomext and Banobras, and through investment vehicle Corporación Mexicana de Inversiones de Capital, SA de CV, or Fund of Funds, which has invested more

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4 id.
than US$885 million in more than 84 funds and co-invested in 17 deals. In addition, the National Institute of Entrepreneurship helped the Mexican VC industry and seed capital ecosystem by investing or co-investing in 41 funds from 2013 to 2016. For 2016, the VC support grew to 100 million Mexican pesos, targeting one fund with an approach to the Asia-Pacific alliance countries, which is now finishing its fundraising period. Finally, domestic pension funds (AFOREs) have played a determinant role in the growth of the PE industry, having allocated more than US$20.4 billion through 106 capital development certificates (CKDs) and investment project certificates (CERPIs) since 2008. This amount may increase by a further US$5 billion, given the CKDs that are in the pipeline. Mexico is seen as one of the most favourable emerging markets to invest in, and is considered top in Latin America according to various limited partner (LP) surveys, such as those conducted by the Association for Private Capital Investment in Latin America in 2014 and 2015, and by the Emerging Markets Private Equity Association in 2015, 2016 and 2017.

Mexico returned to the World Economic Forum’s (WEF) list of the top 10 countries to invest in globally, by rising four positions to number nine, sitting alongside the United States, China, Germany, India, the United Kingdom, Brazil, France, Australia and Japan. The Mexican economy is being reshaped, and in spite of an adverse economic environment, allows dynamism of its international trade, and the structure of its debts minimises the impact of external factors making it a healthy option for investing. The WEF ranks Mexico in 46th place, out of 140 countries, in the 2018 edition of the competitiveness index, which shows that the country has microeconomic and macroeconomic institutions with strong foundations. Mexico is placed as the second-largest economy in Latin America (with an estimated GDP of US$1.222 trillion) and it is considered to have economic stability that has allowed the peso to remain stable despite various difficulties. The Mexican economy has grown at an average annual rate of 2.5 per cent for the past 10 years, mainly because of the implementation of new regulations to improve development, sensible monetary and fiscal policies, ordered management of public finances led by the Bank of Mexico, and a gradual improvement in the country’s external environment, despite a zero per cent growth being estimated for 2019. The World Bank suggests Mexico might be the world’s seventh-largest economy by 2050 – a positive outlook that will only serve to attract direct foreign investment.

Despite the uncertainty generated by the renegotiation over the past two years of the United States–Mexico–Canada Agreement (USMCA), that is purported to supersede the North America Free Trade Agreement (NAFTA), it was finally signed on 30 November 2018; and the Protocol of Amendment to the USMCA, which, among other amendments, ensures that Mexican officials implement the promised labour reforms and adds changes in the agriculture sector, was agreed and signed on 10 December 2019. The ratification and enactment of the USMCA is still pending, but it is expected to happen shortly. The USMCA, among other important changes, includes a specific chapter dedicated to boosting the growth of small and medium-sized businesses by implementing new measures such as incrementing the opportunities for commerce and investment through infrastructure development, promoting small and medium-sized businesses among minorities and start-ups, creating

8 AMEXCAP, ‘Inside Mexico’s PE Market: November 2017’.
a committee dedicated to promoting the competitiveness and cooperation between these types of businesses and keeping entrepreneurs informed of updates and developments. It also includes specialised chapters that regulate e-commerce, agriculture, labour and heavy industry (aerospace and automotive).

The PE industry and the VC sector in Mexico continue to grow and mature. The internationalisation of both funding sources and investment by domestic GPs suggests that Mexico is playing an increasingly influential role in financial and economic growth at both the regional and global levels. Within VC alone, Mexico has witnessed the number of GPs triple in the past seven years. The policies being implemented in Mexico, particularly the opening-up to competition of the energy and telecommunications sectors, and labour market reforms, have been welcome steps to attract investment and raise employment and, potentially, growth. This is evidenced by the extent to which infrastructure and energy funds have also increased significantly, reaching 30 funds in 2016 – a clear effect of the energy reform allowing private investments in the energy sector, including oil and gas, electric power generation and renewable energy. As at October 2017, an estimated US$25 billion in cash reserves were available for investment by PE funds investing in Mexico.

Likewise, accumulated capital commitments from 2018 to September 2019 increased by 1.7 per cent. These capital commitments were mainly concentrated on seed and early stage VC funds. As at September 2019, three new Mexican funds had been formed, bringing the number of funds operating in Mexico to 126, of which 60 per cent are now investing or managing their investments, while almost one-third are still at the fundraising stage.

In general, information about PE funds is not publicly available during the fundraising stage unless the funds are public funds raised in the securities market, such as CKDs, CERPIs or Mexican real estate trusts (FIBRAs).

The Mexican fundraising market has been in an upward trend since 2014. In the past, the most attractive sector has been real estate, but recently the VC sector has clearly been rising. Mexican PE funds are active, growing and covering a large spectrum of industries (business and financial services, consumer goods, healthcare, technology, oil and gas, etc.). VC funds mainly invest in consumer services, fintech and technology; real estate funds mainly target the industrial (mostly automotive, aerospace and pharmaceutical), commercial, tourism and housing sectors; and the infrastructure and energy funds are currently concentrated in the oil and gas sector. In March 2018, the Law Regulating Financial Technology Institutions (the Fintech Law) was enacted, providing for regulation of, among other things, electronic payments, cryptocurrency transactions and crowdfunding mechanisms. According to Fintech Radar Mexico, conducted by Finnovista in May 2019, Mexico is very close to reaching the 400 fintech start-up mark, and, in 2019, it regained leadership as the largest fintech ecosystem in Latin America, in part because of a strong presence of entrepreneurship and e-commerce. The Mexican fintech industry has shown an annual growth rate of 29 per cent, with the creation of 98 new start-ups, with the dominating sectors being loans, payments and

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13 International Monetary Fund, ‘World Economic Outlook: Legacies, Clouds, Uncertainties’ (October 2014).
14 ibid.
16 ibid.
17 Finnovista, Fintech Radar Mexico (May 2019).
remittances.\footnote{18}{Reports from recent years have highlighted the high growth rates of fintech in Latin America, such as LAVCA's 2017 \textit{Trend Watch: Latin American Venture Capital}, which concluded that the fintech sector represents 25 per cent of the venture investments in information technology in the region. According to a survey conducted by Finnovista in collaboration with Endeavor, Mexican fintech companies have a monthly gross transaction value of 39 billion Mexican pesos, with an average of 8.7 million Mexican pesos being billed per fintech start-up per year.\footnote{19}{These results emphasise the importance and the possibilities of fundraising and VC investment in the development of the fintech ecosystem in Mexico. As the fintech industry represents a massive potential growth area in Mexico, the government has passed legislation that seeks to ensure financial stability and provide a defence against money laundering and corruption.}} As mentioned above, Mexican VC has grown significantly, reaching US$1.71 billion in accumulated committed capital over the past 10 years.\footnote{20}{Mexico’s VC sector is now an attractive market in which to invest, with 63 active Mexico-based fund managers and 50 foreign GPs that performed at least one transaction in the past five years. In the same vein, AMEXCAP registered over 1,233 VC transactions for a total of US$1.5 billion invested from 2009 to September 2019 and, on the liquidity side, noted four exits during 2019. The growth seen in 2016 remains the industry record, with the largest number of transactions; however, in terms of the capital invested, the first three quarters of 2019 established an industry record with US$330 million.}}

In the past 19 years, foreign funds have only contributed approximately 10.6 per cent of the total accumulated capital commitments in the Mexican VC industry. However, as the number of foreign and domestic GPs increases, the activity of foreign funds is expected to increase in the Mexican VC industry.

The energy reform, which ended a 70-year chapter of restrictive laws, and dismantled the state monopoly, in the oil and gas and electricity sectors, has opened up investment and the participation of private and foreign companies, including PE funds, in these industries. The Federal Electricity Commission (CFE), in conjunction with the Ministry of Energy, has developed a strategy to increase gas transportation capacity through an expansion of the pipeline network to ensure gas supply for power generation. As at September 2019, there were 22 CKDs investing in the infrastructure and energy sectors, which have raised over 60.6 billion Mexican pesos.\footnote{21}{414 Capital, ‘\textit{Instrumentos Estructurados (CKDs y CERPIs): Actualización trimestral – 3T2019}’ (2019).}}

This constitutional and statutory reform continues to restructure the Mexican energy industry (some say creating it), setting out the framework for the participation of private investment not only in connection with hydrocarbons (including upstream, midstream and downstream activities) but also concerning the electricity industry, which is the sector in which the government and the private sector invest the most. The implications for Mexico’s PE industry are considerable, especially now that the attention has shifted to its implementation. PE funds are able to participate in the oil industry by investing in, or lending to, companies or consortiums of companies bidding in public tenders issued by the Ministry of Energy through the National Hydrocarbons Commission, for the exploration and production of new oil fields, and the Energy Regulatory Commission, in relation to
other energy matters. Considerable numbers of opportunities are starting to arise in any business relating to companies participating in midstream and downstream activities, such as petrochemicals and other transformations of hydrocarbons, and in the transportation of oil and gasoline. According to AMEXCAP, Mexico’s oil and gas value chain could require between US$300 billion and US$400 billion in capital expenditure through to 2020, promoting a significant inflow of outside capital and creating an estimated 2 million jobs by 2025.\(^{22}\)

Furthermore, 2018 and 2019 were strong years in the power infrastructure sector, starting with the completion of the first two phases of the Tres Mesas wind farm project carried out by the Spanish company Abengoa with a total investment of US$80 million and generating 148.5 megawatts; the inauguration of the wind farm Reynosa I, the biggest wind farm in Mexico and one of the biggest in Latin America, involving an investment of US$600 million; and seven more wind farms projects under construction.\(^{23}\) In addition, Mexico is committed to honouring its commitment to the Paris Agreement on climate change. Following the 21st Conference of the Parties of the United Nations Framework Convention on Climate Change in Paris in 2015, at which the Agreement was adopted, Mexico introduced a major new clean energy policy that includes a clean energy target of 25 per cent of electricity generation by 2018, 30 per cent by 2021, and 35 per cent by 2024. This means that, by 2024, participants in the wholesale electricity market will have to satisfy 35 per cent of demand through clean energy certificates, the mechanism devised to guarantee the demand for renewable energy. As at 2018, clean energy in Mexico accounted for more than 24 per cent of the total energy produced in the country.\(^{24}\)

Of the total amount of capital issued in Mexico since 2005, 75 per cent was raised between 2012 and 2017. In 2017 alone, three new funds raised a total of US$705.4 million,\(^{25}\) which clearly reflects that the reforms are working and Mexico’s energy sector is on the right track. We have already seen a significant increase in investment into the power sector and the gas pipelines required to fuel the new thermal power plants tendered by the CFE. International developers continue to arrive and the implementation of the reform continues to shift Mexico’s energy sector in a positive direction; for example, Canadian energy firm TransCanada, in a joint venture with IENOVA and Infraestructura Marina del Golfo, was awarded a contract to construct and operate the US$2.1 billion South Texas–Tuxpan–Tula natural gas pipeline, which is now under construction and will transport natural gas from the south of Texas to Tuxpan, Veracruz, by an underwater route in the Gulf of Mexico. The South Texas–Tuxpan–Tula pipeline is supported by a 25-year transportation service agreement with Mexico’s CFE, and will connect with the Cenagas pipeline system in Altamira, TransCanada’s Tamazunchale pipeline and Tuxpan. The South Texas–Tuxpan–Tula pipeline adds to TransCanada’s portfolio, which also includes a US$550 million contract to construct a 420km gas pipeline from Tula in Hidalgo State to Villa de Reyes in San Luis Potosi. The French energy company ENGIE has invested at least US$300 million to connect its Energía Mayakan natural gas pipeline (a 485-mile pipeline that transports natural gas from Ciudad Pemex in the state of Tabasco to Valladolid in the state of Yucatan) to industrial and tourism users in the state of

\(^{22}\) Everett Rosenfeld, ‘Mexico to receive major economic jolt’, CNBC.com, 2014.


\(^{25}\) AMEXCAP, ‘Inside Mexico’s PE Market: November 2017’.
Quintana Roo. BP expects to increase investment in everything from exploration to retail fuel sales; the British firm is already involved in three offshore projects – two in the Gulf of Mexico’s deep waters and another in shallow waters. The company also launched Mexico’s first foreign-branded gas station, with plans to open some 1,500 stations over five years. Tesoro Corporation (now Marathon Petroleum Corporation) reached a definitive agreement with Pemex for transportation services in Mexico. The agreement enables Tesoro to supply transportation fuels and launch the ARCO brand in the Mexican states of Sonora and Baja California. In addition to the construction of the aforementioned pipelines, representing more than US$2 billion in investment, the private sector has begun to invest in storage, with the largest initiative being Orizaba Energía’s investment of US$115 million to build 2.7 million barrels of capacity in Tuxpan. As at 2019, more than 100 contracts have been awarded to 73 international firms or consortiums, from 20 different countries.

Regarding the infrastructure sector, during late 2019 the Mexican government announced the first project of the New Mexico City airport, which will be operating at the current Santa Lucía military airport. 2020 is foreseen as a great year in the infrastructure sector, due to the National Infrastructure Plan that López Obrador, the Mexican President, revealed in November 2019 to strengthen Mexico’s economy. The plan implies that his government, together with the business industry, will invest a total of 859 billion Mexican pesos in infrastructure projects over the next five years. The plan provides for the investment in 147 major infrastructure projects, and the money will be allocated as follows: half of the investment will be exercised in 2020, while the other half will be deployed over the next four years. Among the 72 projects that will be developed in 2020 is the expansion of the port of Dos Bocas in Tabasco; the expansion and renovation of 17 airports, mainly in the south and south-east of the country; and the development of various roads in the Bajío region, as well as a second highway to the north of the capital. This plan is expected to positively affect the Mexican economy. During 2020, work on the Mayan Train project, that will connect a number of tourist sites around Mexico, is expected to begin. Industries are changing and Mexico’s global competitiveness is increasing as reforms and governmental initiatives modify the structure of the economy to attract investment. The expectation is that Mexico will become a sophisticated design and manufacturing hub rather than remain merely a low-cost producer; a clear example of this is the state of Queretaro, which is growing as a new centre for the aerospace industry, with dozens of multinationals setting up shop in the state’s industry zone and making the most of generous subsidies offered by the government. At the centre of this growth is the Queretaro aerospace cluster, which is host to Safran, Airbus, GE, Aernnova Aerospace México, Duqueine Group, Delta and Bombardier, among others. On the occasion of Mexico’s Aerospace Summit 2019, it was announced that the aerospace industry has grown from 100 US and European producers in 2004 to more than 330 in 2019.

31 Mexico Aerospace Summit: www.mexicoaerospacesummit.com/.

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The Mexican PE market has grown considerably over the past 19 years. The above-mentioned reforms, their proper implementation and a solid economic foundation are likely to foster further growth of the country’s PE industry. Mexico is still viewed as one of the most attractive Latin American markets, not only because of its geographical position (sharing a border with the United States, and with access to both the Pacific and Atlantic oceans), but also because of the number of trade agreements the country has in place, making possible preferential relations with 46 countries; it also offers the benefits of a growing workforce and fiscal prudence.\(^32\) We believe more firms will come to Mexico and reap the rewards of these favourable conditions, thereby continuing to boost PE fundraisings while profiting from the incentives arising from the newly structured legal frameworks, as was seen to be the case during 2015 and 2018.

In connection with the foregoing, in 2015 Mexico’s government introduced two new investment instruments to promote the country’s economic development and, in particular, to boost the PE industry. In September 2015, the creation of the first of these instruments, the FIBRA E (also known as the ‘Mexican MLP’), was announced. The FIBRA E is an investment alternative in the form of an investment vehicle promoting long-term investment in Mexican-qualified energy, electricity and infrastructure assets and the management thereof, to be traded on the Mexican Stock Exchange (BMV) and offered locally and abroad. The FIBRA E allows private and public participants to monetise such assets under a tax regime that reduces levels of overall taxation and, therefore, opens the door for greater distributions. Various amendments have been made to the applicable regulations between 2015 and 2019 to make the instrument more appealing.

In December 2015, CERPIs were introduced. CERPIs allow insurance companies, AFOREs and other (national or foreign) institutional investors to participate in equity projects in all productive sectors of the economy. This comes as a simplified version of the existing CKD providing for a larger scope of decision by GPs and lower investment requirements for investors. In January 2018, certain amendments were made to the applicable regulations to allow AFOREs to acquire CERPIs that invest in portfolio companies outside Mexico (as long as at least 10 per cent of the issue amount is invested in Mexico); this particular amendment will make the instrument more appealing for issuers and AFOREs.

As to the reception by potential LPs of PE funds in the pipeline, public Mexican funds such as CKDs and FIBRAs have been favourably received by Mexican institutional investors (mainly Mexican pension funds) to the extent that the projects are adequately structured and follow the standard market terms and economics of such funds. As to private Mexican funds, their appeal is likely to depend on the recent success and market credibility of the sponsors or GPs of those funds. Reflecting the industry’s appetite for financing new projects within the asset class, the first issuances of the recently introduced FIBRA E and CERPIs took place at the end of 2016. The growth of the energy sector and amendments to the applicable regulations might well result in an increase in the issuances of these instruments.

Depending on the structure used to implement a PE fund, the time frame for PE fundraisings may vary. As an example, if the creation of a public PE fund is carried out through the issuance of CKDs, FIBRA Es or CERPIs, the time required to raise the fund may range from six to 12 months. For clarity, PE funds are generally structured as a CKD (and, as of 2016, a CERPI) to allow them to raise commitments from the AFOREs, which have

\(^{32}\) Antonio Martinez Leal and Pino del Sesto, ‘Private Equity in Mexico: Primed for significant growth’, 16 May 2013, Bain and Company.
very restrictive investment rules and can generally only invest in projects through these kinds of securities. Such funds are formed through Mexican trusts created to issue the CKDs or CERPIs to be placed and offered through a public offering on the Mexican stock exchanges, and managed by GPs incorporated in Mexico. Most CKDs are issued to invest in portfolio companies in Mexico subject to the investment policies determined by the sponsor. At the time of writing, over 92 CKDs have been issued to try to access a portion of the billions of dollars managed by the AFOREs that can be invested in this type of security. There are approximately 23 CKDs in the pipeline pending approval, which would capture around 67.8 billion Mexican pesos.\(^{33}\) On average, 10 CKDs have been listed per year since 2010.

The same timeline applies for Mexican FIBRAs that raise capital through the issuance of real estate certificates, which are generally publicly offered on the BMV but can also be offered in foreign markets. The funds raised by FIBRAs can only be invested in commercial real estate projects and developments (industrial, retail and hospitality), and are structured as Mexican trusts to which real estate assets are conveyed by the original owners that, in exchange, receive real estate certificates.

The timeline for privately placed PE funds structured through Mexican or foreign vehicles will vary depending on the market conditions.

As positive evidence of the market appetite, during July 2018, a new Mexican stock exchange, the Bolsa Institucional de Valores (BIVA), began operations. The BIVA seeks to increase the operations on the Mexican market as an alternative to the BMV by easing the requirements that the latter imposes for its listings.

Below are recent deals that were made publicly available.

In March 2019, VMZCK 17 made the first investment in the company Aqua Salus, also known as The Water House, that wholesales purified water, for a total of 95 million Mexican pesos. The investment will be dedicated to the growth and expansion of the company.\(^{34}\)

In April 2019, Redwood Ventures added Crabi, the first car insurance company in Mexico to use artificial intelligence to grant policies to its users, which has a value of approximately US$5.4 billion, to its portfolio.\(^{35}\)

In July 2019, DILA Capital announced its investment in Smart Lending, the sole Fintech mortgage lender in Mexico, which has secured approximately US$80 million in equity and debt.\(^{36}\)

In July 2019, Adobe Capital announced the final closing of Adobe Mezzanine Fund II, LP with a total amount of US$30.3 million.\(^{37}\)

In September 2019, IGS Group authorised a capital increase for a total of 2 billion Mexican pesos because of the accelerated and successful pace of investment. The capital will be invested in industrial warehouses all around Mexico.\(^{38}\)


In October 2019, Alta Growth Capital joined a group of investors to invest in Lottus Education, which is a leading platform of higher education in Mexico offering education to 40,000 students through two different universities, among other things.\(^3^9\)

In November 2019, Nexxus completed the divestiture of Krispy Kreme Mexico, which was acquired by Krispy Kreme Doughnut Corporation, which owns the brand worldwide.\(^4^0\)

## II LEGAL FRAMEWORK FOR FUNDRAISING

The Canadian limited partnership has been one of the most popular legal forms for structuring PE funds with Mexican LPs’ investment as they are considered transparent for tax purposes; however, certain amendments to the Mexican tax laws will restrict such transparency regime from 2021. Other vehicle structures used in Mexico include the PE investment trust and the FICAP, a Mexican trust that is not considered an entity under Mexican law and that has a specific set of tax rules created to incentivise PE investments. To raise funds from investors, FICAPs issue certificates that can be either publicly placed through the BMV and more recently through the BIVA (the most recent CKDs are FICAPs) or privately issued. FICAPs are exempt from complying with certain management and tax payment obligations. The fundamental characteristic of the FICAP is that the trust is subject to a transparent regime for tax purposes, and thus the regime allows the investors to directly recognise the income generated through the trust (dividends, capital gains and interest payments) as if they had obtained the income from investing directly in a Mexican target entity. Another form that is used by PE funds is the SAPI, which is mainly a Mexican corporation that provides great flexibility to structure different kinds of businesses (including PE funds), and also increases the protection offered to minority shareholders and provides exit strategies.

The key legal and negotiable terms of PE funds will depend on the vehicle chosen, but will be very similar to those in other jurisdictions (e.g., the term of the fund, investment policies, management of the fund and documentation of the relationship between the manager and the fund, fees, carried interest and exits for limited partners).

One of the key issues for a Mexican PE fund is its management. In connection with CKD funds, for example, the sponsor will normally act as the manager, and will carry out the business of instructing the trustee to make the required investments in eligible projects; however, pursuant to Mexican securities law, it would also require the approval of the limited partners for relevant investments or actions, which causes the limited partners of CKDs or FIBRAs to have an active role in the management of the fund. All CKD and FIBRA investments are subject to certain guidelines (including bondholder meeting approval). Nevertheless, the structuring of CKDs has improved over time, and has evolved to the extent that CKDs are released from rules that previously prevented deals from taking place. In addition, we have noticed that management fees and carried-interest fees have changed over the past five years. The tendency has been for such fees to decrease (e.g., some CKDs had management fees amounting to around 2 per cent of the total amount invested during the investment period in 2009; currently, the management fees for 2017 transactions range between 1.5 and 1.75 per cent of the total amount invested during the 2016 investment period).


We have also noted that rather than the usual passive limited partner role, certain institutional investors are seeking a more active role in traditional PE funds.

The SAPI is governed by federal law and, more specifically, by the Securities Market Law; all items not covered by the Securities Market Law are regulated by the General Law of Business Organisations. However, the SAPI is not subject to obligations applicable to public corporations nor to supervision by the National Banking and Securities Commission (CNBV); therefore, no disclosure obligations have to be met.

PE funds are reluctant to share information because of potential threats posed by competitors and other factors. However, if the PE fund is structured through a CKD, investors and fund managers must take into consideration that CKDs are publicly listed vehicles; as such, they are obliged to disclose certain information, and their issuers have the same disclosure obligations as other debt issuers according to Mexican regulations.

Disclosure obligations include the filing of quarterly and annual reports to the BMV that include updates and annual audited financial statements, as well as a duty to disclose any information necessary for investors to carry out investment decisions.

Depending on the structure of the PE investment, the method of investment solicitation at the fundraising stage may vary.

PE funds may raise capital by privately soliciting sophisticated investors in Mexico under the Mexican safe harbour rule, which allows the offering of securities to such investors in a private placement. For public funds, such as CKDs, CERPIs or FIBRAs, solicitation is open to the general public (any kind of investor, person or entity, whether Mexican or foreign), although, generally, such funds target investments by institutional investors such as the AFOREs, insurance companies and sophisticated investors who are private banking clients. Public funds such as CKDs, CERPIs and FIBRAs are also subject to certain solicitation and publicity guidelines applicable to all issuers on the stock market.

GPs of PE funds formed as Canadian limited partnerships may be subject to certain Canadian regulations applicable to GPs.

Regarding Mexican vehicles, in structures such as SAPIs, the fiduciary duties of care and loyalty (such as conflicts of interest, disclosure and informational duties) are established contractually. Furthermore, the adoption of the Best Corporate Practices Code issued by the Mexican Business Coordinating Council and the guidelines from the Mexican Institute for Competitiveness is encouraged, and many funds have adopted these practices regarding corporate governance and fiduciary duties.

Regarding CKDs, CERPIs and FIBRAs, the manager of the fund is normally also the fund’s sponsor and, in line with its responsibilities to carry out the fund’s projects, it must comply with the resolutions and policies of the trust’s technical committee; the committee will set up the terms and conditions of the manager’s duties, and must reject any transactions that may involve a conflict of interest. Recently, it has become more common that managers of CKDs, CERPIs or FIBRAs are subject to the same fiduciary duties as directors of Mexican public companies pursuant to the federal Securities Market Law.

The FIBRA E must be structured as a Mexican trust. The applicable tax rules provide that the trust must be formed following many of the requirements applicable to FIBRAs, but with certain differences: up to 30 per cent of the trust’s book value must be in federal government bonds or shares of mutual funds that may invest only in fixed income securities; and investments in shares of Mexican companies must comprise at least 70 per cent of the trust’s book value. Further, those Mexican companies must comply with the following: (1) the shareholders of the company (other than the trust itself) must be Mexican resident
companies (this requirement does not exclude foreign investors in any manner, and they will be entitled to own shares of the underlying company through the trust or through a Mexican subsidiary, although depending on the amount of the investment, antitrust and foreign investment approvals may be required); (2) the corporate purpose of each company must be a Mexican-qualified energy, electricity and infrastructure asset-related activity, the management thereof, or a combination of these activities, and at least 90 per cent of the annual taxable income of the FIBRA E should stem from qualified energy, electricity and infrastructure assets; and (3) the investments of the company must be in brownfield or qualified greenfield projects, as new assets may represent only 25 per cent of the book value.

III REGULATORY DEVELOPMENTS

Except for publicly placed PE funds (such as CKDs, FIBRAs, FIBRA Es and CERPIs), there is no regulatory oversight of Mexican PE funds or their fundraising processes (other than the safe harbour rule mentioned in Section II).

CKDs, FIBRAs, FIBRA Es and CERPIs are governed by the federal Securities Market Law and its ancillary regulations, and their main regulator is the CNBV. CKDs, FIBRA Es, FIBRAs and CERPIs are supervised and regulated to ensure the proper operation of the financial system and to protect the interests of the general public. In consequence, issuers are subject to quarterly and annual reporting obligations, such as presentation of audited financial statements, and the registration of the fund requires the previous authorisation of the CNBV and the BMV.

Other forms of PE funds are not under any obligation or requirement to be registered in Mexico, and the sponsors or GPs do not have to be registered in any special registry in connection with their activities as fund managers.

Depending on the legal form of the PE fund, the tax rules can vary; thus, the specific tax regime applicable to the investors may also vary. Nonetheless, generally the vehicles chosen (including limited partnerships and FICAPs) are structured in a manner that allows them to be considered tax-transparent vehicles, which implies that the income realised is directly recognised by the investors.

In the case of foreign limited partnerships, a tax-transparency regime may be achieved to the extent that such partnerships are created in a country with which Mexico has a broad agreement for the exchange of information; that they do not have a legal personality of their own, separate from that of their members; and that they are tax transparent in their country of formation. If these requirements are met, the limited partnership will be treated as being tax transparent for Mexican purposes, and thus the investors will be entitled to apply any benefits that may be included in any relevant double taxation treaty. From 2021, additional requirements will need to be complied with to preserve such transparency, including the disclosure of the investors acting as limited partners.

FICAPs, on the other hand, are also tax transparent, and are governed by a special set of tax rules that defines the withholding obligations applicable to the parties involved, as well as the moment at which the investors participating in FICAPs shall be liable to tax. More specifically, according to the rules, the investors shall be liable to Mexican tax upon receiving a distribution from the FICAP, and the tax regime actually applicable to each investor will be contingent on the nature and country of residence of the investors (e.g., institutional, foreign or local, tax-exempt or taxable).
Certain requirements under Mexican tax provisions must be met to qualify as a FICAP:  

a. FICAPs shall invest at least 80 per cent of the trust assets in stock issued by Mexican target entities (not publicly listed at the time of the investment) or granted as loans to such entities;  
b. the remaining percentage that is not invested in stock issued by Mexican target entities or granted as loans to such entities shall be invested in securities issued by the federal government or in Mexican debt mutual funds;  
c. the acquired stock shall be held for at least two years; and  
d. at least 80 per cent of the income realised by the FICAP should be distributed within two months of the end of the tax year. If these thresholds are not reached, the trust will not qualify as a FICAP and, thus, will not benefit from the specific tax rules applicable to that vehicle.

Slight changes were made to the tax regime applicable to FICAPs in 2016; in particular, it should be highlighted that the limitation for the application of the FICAP regime for a maximum of 10 years has been repealed. In the case of FIBRAs, two additional requirements were included as part of the amendments made to the income tax legislation for 2014 (and that resulted in a new Income Tax Law): in the case of lease agreements where the consideration is established as a variable amount or based on a percentage, this type of income cannot exceed 5 per cent of the aggregate income of the FIBRA unless the rental payment is established as a fixed percentage of the sales of the lessee; and trusts operating as FIBRAs must be registered with the tax authorities. In addition, certain measures were included in the applicable securities rules to limit the ability of FIBRAs to incur debt. And more recently, the possibility has been established for the FIBRA trust to repurchase its own certificates, subject to several conditions.

As for the recently enacted FIBRA E, the main features of the tax regime that has been established may be summarised as follows.

a. Both the underlying Mexican companies in which the trust invests and the trust itself shall be treated as tax transparent, and the certificate holders will directly recognise the tax result of the FIBRA E as computed by the trustee under the specific rules (no monthly or annual income tax payments are required at the trust or underlying company levels).  
b. In computing the tax result of the trust, the trustee shall consider the tax profits generated by the underlying companies (but not the tax losses, which may only be carried forward by the entity that generated them) and a deductible deferred expense, equal to the gain generated by the seller of the shares acquired by the FIBRA E trust as per below.  
c. The persons selling shares to a FIBRA E will be required to recognise the gain derived from the sale of the assets owned by the company whose shares were sold (instead of recognising a capital gain on the actual sale of shares).  
d. The trust will be required to distribute on a yearly basis at least an amount equal to 95 per cent of its annual tax result, using the proceeds distributed by the underlying companies.  
e. The aforementioned distributions will not be considered dividends for tax purposes and thus the 10 per cent dividend tax will not apply.
Certain specific rules were enacted to allow the spin-off or otherwise segregate qualifying assets to special purpose vehicles in a tax-efficient manner, provided that at least a certain number of the shares in the resulting vehicle are subsequently sold to a FIBRA E within six months.

Mexican-resident individuals and non-resident investors will be exempt from withholding tax on the sale of the certificates issued by the FIBRA E, provided that the sale takes place through an authorised exchange.

IV OUTLOOK

The private equity industry in Mexico has been re-energised in recent years by government reforms and policies, a stable macroeconomic situation, stable population growth rate, an increase in real income and an active entrepreneurial ecosystem.

Mexico has successfully completed USMCA (which is expected to supersede NAFTA) negotiations with the United States and Canada and has gone through a smooth, peaceful and democratic power transition following the presidential election that took place in July 2018, providing certainty to investors. However, Mexico’s intention of being prepared for any scenario is clear from its aim to increase trade with Argentina and the Pacific Alliance (Colombia, Peru and Chile), as well as with the European Union and Asian countries, and from the government’s continued efforts over the past few years in the infrastructure and energy sectors.

While the forecasts are moderately strong, we expect contract and investment opportunities to be abundant as government policies support a shift towards a larger role for private investment in the Mexican infrastructure industry and in the still-booming energy industries. Opportunities will also be presented by the continuing rise of the fintech industry. The outlook for the Mexican PE industry is, therefore, positive, with local funds becoming more global and deploying capital, and investments by foreign funds increasing throughout the energy sector. If conditions remain the same and the growth rate remains at the levels we have been seeing, the PE industry should, according to AMEXCAP, reach US$80 billion by the end of 2020.

We predict that the regime governing publicly issued PE funds will continue to be improved, and that the regulations regarding investment restrictions applicable to Mexican pension funds will necessarily evolve towards alignment with the types of regimes seen in other, more evolved countries, allowing the pension funds to conduct private transactions and investments in funds or projects directly (rather than only through publicly issued securities such as CKDs, FIBRAs, FIBRA Es and CERPIs).
Chapter 13

NORWAY

Peter Hammerich and Markus Heistad

I  GENERAL OVERVIEW

During the past 25 years, the Norwegian private equity market has matured and become more internationalised. Several factors seem to have contributed to the development of the sector. One factor has no doubt been the establishment of Argentum Fondsinvesteringer AS in 2001. Argentum is a government-owned investment company established to make private equity investments. It has committed substantial amounts in funds managed by Norwegian and Nordic managers since its inception, and had a portfolio valued at 7.6 billion Norwegian kroner at the end of 2018.2 Another factor may have been the advent of the Alternative Investment Fund Managers Directive (AIFMD). Before this, the Norwegian private equity sector was wholly unregulated. The AIFMD has introduced regulation, and resulted in work towards the standardisation and institutionalisation of the actors in this sector.

The size of the Norwegian fundraising market may be viewed from the perspective of the sponsors (in terms of potential for committed capital), and from the perspective of the amount of funds raised by Norwegian sponsors.

There are no statistics concerning the size of the Norwegian market in terms of potential for committed capital. The Norwegian economy is, however, relatively small, meaning that the fundraising market is small and therefore sensitive to vintage years.

With respect to the amount of capital raised by Norwegian sponsors,3 2018 saw the low total of 4.5 billion Norwegian kroner, up from 0.9 billion Norwegian kroner the year before.4 Illustrating the volatility between different vintage years, 2016 saw record high fundraisings, amounting to 22 billion Norwegian kroner.5 The figure for 2007 was 4.8 billion Norwegian kroner.6

A notable fundraising by Norwegian sponsors in 2019 was Explore Equity I (€840 million).

Notwithstanding this, globally the trend has been towards larger fundraisings, with firms having established their track record and a more international investor base. Further, more firms have come to market than in previous years. Although the barrier to entry for new

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1 Peter Hammerich is a partner and Markus Heistad is a senior lawyer at BAHR.
2 Source: Argentum 2018 annual report.
3 Defined as capital raised through funds advised or managed by a firm with its head office established in Norway (Norwegian Venture Capital and Private Equity Association (NVCA)).
4 NVCA 2018 activity report.
5 NVCA 2017 activity report.
6 NVCA 2016 activity report.
sponsors is low from a purely regulatory point of view, significant fundraisings by newcomers are the exception rather than the rule, as they will rarely be able to demonstrate any track record, unless they are spin-offs from previous sponsors or internal asset management departments.

The duration of fundraisings varies quite significantly, from a handful of weeks until almost a year, depending on whether the sponsor provides an offering that corresponds to investor demand.

We expect the local market to grow somewhat in the coming years. Since 1 January 2019, Norwegian pension funds have been subject to new solvency rules based on a simplified version of the EU Solvency II rules, including investment freedom. This means that both Norwegian insurers and pension funds now are free to increase their allocation to private equity, where previously statutory investment restrictions held these at low levels, and perhaps lower than an optimal portfolio allocation and asset liability management should suggest.

II LEGAL FRAMEWORK FOR FUNDRAISING

Norway is a Member State of the European Economic Area (EEA). As such, the main body of legislation regulating the financial sector consists of EU legislation transposed into Norwegian law. Management and marketing of private equity fund managers are regulated under the Norwegian Alternative Investment Fund (AIF) Act, transposing the AIFMD.

At the fund level, private equity funds are unregulated in Norway. Closed-ended funds, and open-ended funds investing in asset classes other than financial instruments and bank deposits (e.g., real property, commodities (directly, and not in derivatives)), generally fall outside the scope of the Norwegian Investment Fund Act. Although it is expected that the EU-regulated fund types European Venture Capital Funds (EuVECs), European Social Entrepreneurship Funds (EuSEFs) and European Long-Term Investment Funds (ELTIFs) will be introduced into Norwegian law, these regulations are not yet incorporated into the EEA Agreement or implemented into Norwegian law. Consequently, legal form and key legal terms for private equity funds are primarily shaped by investor expectations and based on international market standards.

The preferred jurisdictions for the establishment of funds by Norwegian firms have traditionally been Norway for smaller funds, and the Channel Islands for larger funds by sponsors that also target non-Norwegian investors.

In terms of legal form, the preference has been for companies that are tax-transparent for the purposes of Norwegian tax law, namely limited partnerships, with a general partner having invested an amount into the partnership directly. In the past, smaller Norwegian private equity funds were also established as limited companies.

Following Brexit, several fund managers are assessing whether to move new funds to within the EEA or to establish parallel structures inside and outside the EEA. Luxembourg is likely to be the most natural jurisdiction for such funds, and some fund sponsors have made this choice for their most recent funds (e.g., Explore Equity, Norvestor VIII).

Key legal terms for private equity funds correspond to those of market standard private equity funds established as limited partnerships. Outside commercial considerations such as a team’s potential for deal sourcing, prospective investors may be expected to be primarily concerned with the correlation between total fund size and management fee, risk alignment or carried interest investment by the team, key man provisions, length of investment or commitment period and of term, and conditions for extending the investment period or term. Fundraisings in the institutional market typically see extensive negotiations over key terms.
It is standard market practice and a clear investor expectation for funds to include a most-favoured-nations clause with respect to side letters. For authorised managers, this is also likely to be required under the AIF Act, as is the obligation of fair treatment of investors, whereby any preferential treatment accorded to one or more investors shall not result in an overall material disadvantage to other investors. Side letters have begun to represent a major compliance burden for managers as these bespoke demands are becoming more extensive and may often include more discretionary elements, such as environmental, social and governance (ESG) reporting. It remains to be seen whether cost-saving measures and an increased compliance burden in general will force a larger degree of standardisation and reduce the current willingness of sponsors to negotiate side-letter regulation.

Following the entry into force of the Norwegian transposition of the AIFMD, authorised managers are subject to statutory disclosure requirements to both investors and to competent authorities, both with respect to pre-investment disclosures and ongoing disclosures. Disclosures are, however, primarily market-driven, and investors typically require more extensive disclosures than those required by law alone.

The trend for increased disclosure requirements is mainly driven by institutional investors such as insurers and pension funds, which typically require more extensive ESG reporting, as well as financial reporting, making insurers capable of employing the Solvency II ‘look-through’ approach for calculating capital requirements. Good quality financial reporting is also required by fund-of-funds investors that have become large investors in private equity funds.

The AIF Act imposes certain requirements with respect to ongoing reporting to investors, and requires periodic reporting to the competent authorities. Institutional investors will typically have specific reporting requirements, such as insurance companies (and, going forward, Norwegian pension funds – see Section I) subject to Solvency II capital requirements, and be obliged to adopt the look-through approach to the underlying investments of a private equity fund.

Following entry into force of the AIF Act, marketing of interests in private equity funds is regulated under the AIF Act. The AIF Act and its marketing rules have had a substantial impact in the Norwegian market. While marketing of unregulated funds previously could be made without specific restrictions (other than prospectus rules, general marketing law and rules regulating investment services), the AIF Act introduced common marketing rules for all types of alternative investment funds.

The marketing rules differ depending on the jurisdiction of the manager and the fund, whether the manager is authorised or registered, and the jurisdiction of target investors.

The AIF Act and the implementation of the AIFMD in Norway are to a large extent based on a copy-out approach, with little or no ‘gold-plating’. Norway has implemented the AIFMD thresholds, allowing for light-touch regulation of managers of smaller funds that are not mutual funds (in simple terms, less than €500 million for closed-ended funds and less than €100 million for open-ended funds).

For private equity managers, that threshold will typically be €500 million, as funds as a rule are unleveraged at the fund level. In practice, the authorisation requirement will be triggered by the fact that the manager wishes to manage a fund established outside Norway, or to market fund interests to investors that are not professional according to the definition in the AIFMD. Norwegian rules concerning marketing of interests in AIFs to non-professional investors require that the manager is authorised under the AIFMD.
Whether or not the fund sponsor corresponds to the fund manager (on which the onus of regulation of the AIFMD lies) will vary depending on how the fund structure has been organised. Norwegian private equity funds will typically be managed by an external manager that is either registered or authorised. Internally managed private equity funds are rare. Certain larger sponsors with funds established outside Norway and the EEA, typically the Channel Islands, may have a structure where the manager (typically the general partner) is also established in the Channel Islands, and any Norwegian entities operate in an advisory function to the general partner. Advice in the context of private equity funds has been viewed by the Financial Supervisory Authority of Norway (FSAN) as being outside the scope of investment advice as defined in the Markets in Financial Instruments Directive (MiFID II). This mode of organisation requires that the actual management of the fund is undertaken outside Norway, and that the advisory company does not engage in investment advice or any other regulated activities.

Marketing of Norwegian unregulated funds by managers falling below the threshold values of the AIFMD and established in Norway are not subject to the specific marketing notification rules under the AIF Act. Managers of sub-threshold funds may opt in to benefit from the marketing passport under the AIFMD.

Norway has implemented the private-placement provisions of the AIFMD with respect to funds and managers established outside the EEA. On this point, however, the rules are somewhat more strict than under the AIFMD, as they require prior authorisation from the FSAN to market, rather than relying on notification only. In addition, for fund managers established outside the EEA, there is a requirement that they are registered with a competent authority and subject to prudential supervision in their home state for the purposes of asset management.

If the interests issued by unregulated investment funds are financial instruments, then services related to those interests (such as arrangement services or second-hand share sales) constitute investment services that fall within the scope of MiFID II, transposed into Norwegian law through the Securities Trading Act (the ST Act). Note that, under Norwegian law, interests in limited partnerships are generally not viewed as financial instruments, but there is a specific extension of the scope of the ST Act to include interests in limited partnerships where those interests represent a commitment of less than 5 million Norwegian kroner or the investors are not professional investors per se according to the definition in MiFID II.

In addition, the offer of interests that are financial instruments may trigger a requirement to publish a prospectus under the public offering rules of the ST Act, unless an appropriate exemption is available.

Marketing of private equity funds to non-professional investors requires a separate authorisation by the FSAN, and is only available to funds managed by an EEA-authorised alternative investment fund manager (AIFM).

There have been few supervisory actions in the private equity segment, largely because the majority of funds have targeted institutional and professional investors. The FSAN has primarily focused on monitoring activities by sub-threshold managers in respect of non-professional investors, and in particular, upon reverse solicitation. The FSAN will typically require firm documentation for reverse solicitation to substantiate that no marketing has been undertaken with respect to non-professional investors without authorisation.

The scope of fiduciary duties that a fund manager owes to the fund investors is different for authorised AIFMs and for registered AIFMs.
Authorised AIFMs are subject to overarching business-conduct rules, as further specified in the AIF Act and the AIFM delegated regulation. Registered AIFMs are only subject to contractual obligations towards fund investors, and general marketing and contract law.

Authorised AIFMs are required to appoint a single depository to each fund under management. This includes unregulated funds not previously subject to such a requirement. Although there are a limited number of available Norwegian service providers in this segment, this has not proven to be a bottleneck for the establishment of new funds. However, the FSAN has proved sceptical of depositaries in the same group as the AIFM. Further, authorised AIFMs are subject to specific requirements concerning internal organisation, including separation of risk management, and valuation and compliance functions, as well as rules limiting their activities to managing alternative investment funds and certain MiFID investment services as ancillary activities subject to prior authorisation. Authorised AIFMs may therefore also offer managed account products provided that the AIFM has the relevant authorisation.

III REGULATORY DEVELOPMENTS

i Regulatory oversight and registration obligations

Following the transposition of the AIFMD into Norwegian law, private equity fund managers and their activity fall under the oversight of the FSAN. Pursuant to the AIF Act, the FSAN is responsible for the oversight of managers – including both registered and authorised managers – and indirectly the funds managed by such managers. The Consumer Authority has oversight of actors in the financial sector providing services to consumers, including investment products such as private equity fund interests offered to consumers, and the marketing of such products and services.

The EU Packaged Retail and Insurance-based Investment Products Regulation (the PRIIPs Regulation), which has a requirement for a key information document (KID) when making interests in private equity funds available to non-professional investors, has not been implemented in Norwegian law. Instead, there are non-EEA-based rules requiring a KID to be drawn up to obtain authorisation to market AIFs to non-professional investors. For asset managers active in the retail markets the impact of the PRIIPs Regulation may introduce increased competition and cost transparency. Higher costs and risks connected to retail products may also lead to reduced competition, if non-Norwegian sponsors do not find the market large enough to warrant the investment. Distribution of private equity interests in the retail segment is also be affected by MiFID II and stronger investor protection rules. The new rules on inducements under MiFID II may affect sponsors in terms of how they can distribute funds in a cost-effective manner. It remains to be seen whether the increased transparency offered by PRIIPs will also affect the marketability of different segment (and higher-cost) funds in the retail markets, and whether this transparency will also affect the approach of institutional investors, especially smaller institutional investors that are not large enough to directly influence costs of management.

The coming year or two will likely see the advent of both statutory ESG requirements and higher investor requirements in that field. The Norwegian Ministry of Finance seems to prioritise implementation of EEA (EU) legal acts in this field, and the FSAN is focused on avoiding adverse effects of ‘greenwashing’ in the financial markets. For private equity fund managers, the increased focus will likely require them to integrate ESG into their investment and risk management processes to a higher degree than what has been the case to date.
As mentioned above, private equity funds are not regulated at the fund level in Norway. The EU regulations concerning the EuVECA, EuSEF and ELTIF regulated fund types have not been incorporated into the EEA Agreement or implemented into Norwegian law. There are therefore no specific regulatory requirements concerning the funds themselves. However, the rules of the AIF Act, which apply to fund managers, require that the funds are registered with the FSAN as being managed by the manager, irrespective of whether the manager is a registered or authorised AIFM. Further, certain provisions of the AIF Act, such as those concerning valuation, will have some bearing on the terms of the fund. In June 2019, the FSAN issued a circular concerning project finance companies and the scope of the AIF Act. Project finance companies that are single asset funds have been widely distributed in both the professional and retail spaces, as it has been the market view that these were outside the scope of the AIF Act. Pursuant to the FSAN circular, the FSAN holds that most such undertakings constitute AIFs subject to the AIF Act, unless they are joint ventures or the investors otherwise have day-to-day discretion or control.

Registered and authorised AIFMs are equally subject to the Norwegian anti-money laundering act (transposing the EU Fourth Anti-Money Laundering Directive into Norwegian law) and the General Data Protection Regulation (GDPR), as well as to requirements under tax reporting legislation implementing the Foreign Account Tax Compliance Act (FATCA) and the Organisation for Economic Co-operation and Development Common Reporting Standard (CRS).

ii Taxation of Norwegian funds and investors

With respect to taxation of Norwegian private equity funds and investors, Norwegian taxation broadly depends on whether a Norwegian fund is transparent (typically a limited partnership) or opaque (typically a limited liability company) for Norwegian tax purposes.

iii Taxation of transparent Norwegian funds and their investors

A transparent fund is not subject to Norwegian taxation. Instead, the income, gains, costs and losses of the fund are calculated at the level of the fund and taxed at the hands of its investors on a current basis (irrespective of whether the fund makes any distributions).

An investor (Norwegian or foreign) is taxable for its share of the fund’s net income and gains at the ordinary tax rate of 22 per cent (25 per cent if the investor is subject to the financial tax rate; see Section III.vi). However, any gains deriving from the fund’s qualifying equity investments (see Section III.v) are tax-exempt, while any dividends from such investments are subject to effective taxation (3 per cent of dividends taxable at the ordinary tax rate) of 0.66 per cent (0.75 per cent if the investor is subject to the financial tax rate).

An individual investor is further subject to an effective tax rate of 31.68 per cent on distributions from the fund to the extent they are not treated as tax-free repayments of paid-in capital, as well as on gains upon disposal of interests in the fund. The individual investor is, however, allowed a deduction in the distributions or gains for any taxes paid by the investor on the income and gains of the fund, and is further allowed a minor shielding deduction.

A corporate investor is subject to 0.66 (0.75) per cent effective taxation on distributions from the fund (3 per cent of distributions taxable at the ordinary tax rate), to the extent they are not tax-free repayments of paid-in capital. The corporate investor is tax-exempt on any gain upon disposal of interests in the fund, provided at least 90 per cent of all equity
Norway

investments held by the fund have been qualifying equity investments (see Section III.v) for a consecutive period of at least two years immediately prior to the investor’s disposal. Otherwise, the gain would be subject to the ordinary tax rate of 22 (25) per cent.

An investor may generally deduct costs, although a corporate investor may not deduct acquisition or realisation costs related to qualifying equity investments. Losses are generally deductible to the extent corresponding gains would be taxable, but with certain limitations that are not dealt with further in this chapter.

The above generally applies to both Norwegian and foreign investors, but the foreign investors may, for example, be exempt from Norwegian taxation under an applicable double-tax treaty, and certain other deviations may apply.

iv Taxation of opaque Norwegian funds and their investors
An opaque fund in the form of a limited liability company is subject to the ordinary tax rate of 22 per cent on its income and gains. The rate is 25 per cent if subject to the financial tax rate (see Section III.vi). However, any gains deriving from the fund’s qualifying equity investments (see Section III.v) are tax-exempt, while any dividends from such investments are subject to effective taxation (3 per cent of dividends taxable at the ordinary tax rate) of 0.66 per cent (0.75 per cent if the investor is subject to the financial tax rate). Such dividends are fully exempt from taxation if they are paid by an EU or EEA-resident company in which the fund holds more than 90 per cent of both share capital and votes (subject to certain conditions). The fund may generally deduct costs to the extent that they are not acquisition or realisation costs related to qualifying equity investments. Losses are generally deductible to the extent that corresponding gains would be taxable, but with certain limitations that are not dealt with further in this chapter.

A Norwegian individual investor is subject to an effective tax rate of 31.68 per cent, minus a minor shielding deduction, on gains and dividends from the fund, and is entitled to deductions for associated costs and losses.

A Norwegian corporate investor is tax-exempt on any gains from the fund and is subject to effective taxation (3 per cent of dividends taxable at the ordinary tax rate) of 0.66 (0.75) per cent on any dividends from the fund. Correspondingly, losses are not deductible.

A foreign investor is in general subject to 25 per cent Norwegian withholding tax on dividends from the fund, while any gain upon disposal of interests in the fund is not subject to Norwegian taxation unless the shares are connected to a permanent establishment maintained by the foreign investor in Norway. The foreign investor may be entitled to a reduced withholding tax rate under an applicable double-tax treaty. Foreign corporate investors that are genuinely established and carrying on genuine economic activities within the EEA are normally exempt from withholding tax. Further, individual investors resident within the EEA may claim a reduced withholding tax if the withholding tax exceeds the net taxation that would have been borne by a Norwegian individual investor. Certain documentation requirements for the right to reduced withholding tax at source were introduced on 1 January 2019.

v Qualifying equity investments
Norway has a tax-exemption method that applies to qualifying equity investments. Qualifying equity investments include (1) shares in Norwegian limited liability companies and similar opaque entities, (2) shares in corresponding EEA limited liability companies, provided the
EEA company in question is not a wholly artificial arrangement established in a low-tax country, and (3) shares in corresponding non-EEA limited liability companies, provided the non-EEA company is not resident in a low-tax country, and further provided the fund holds at least 10 per cent of the share capital and votes of the non-EEA company for at least two consecutive years. Qualifying equity investments further include investments in tax-transparent entities, provided that at least 90 per cent of all equity investments held by the transparent entity have been qualifying equity investments for a consecutive period of at least two years.

vi Financial tax rate
Since income year 2017, a specific finance tax has applied to Norwegian asset managers (and Norwegian branches of foreign asset managers). The tax is composed of two elements; a 5 per cent tax on the aggregate payroll expenses and a 25 per cent tax on net income (compared to 22 per cent, which is the ordinary tax rate for 2020).

vii Carried interest
For funds sponsored by Norwegian managers, the right to carried interest normally depends upon the investors having received payment for the entire contributed amount, in addition to a minimum return (typically 8 per cent). The excess proceeds are normally divided (usually 80:20) between the investors and those who have the right to carried interest.

The year 2013 saw the first court case on taxation of carried interest, involving the management company Herkules Capital and three partners. The case concerned the validity of a reassessment of income for 2007 by the tax authorities against Herkules Capital and the three partners, who had received amounts under carried interest. The tax authorities had concluded that the amounts – which had accrued to the partners’ personal wholly owned investment companies – constituted ordinary income (salary) for the relevant persons, and that the amounts received by the general partner were taxable as business income in the hands of Herkules Capital.

After an annulment of the tax authorities’ reclassification in the court of first instance (district court) and a full win for the tax authorities in the court of appeal, the Supreme Court rendered its judgment on 12 November 2015. The Supreme Court found that the amount of carried interest received by the partners’ investment companies was not taxable as ordinary income (salary) for those persons. Further, the court found that the part of the carried interest amount received by the general partner corresponding to the partners’ share could not be reallocated to Hercules Capital as business income. In coming to its conclusion, the Supreme Court emphasised that the taxation of carried interest must be based on the agreed allocation of income between the parties (unless the agreed allocation constitutes a tax avoidance in breach of the general anti-abuse rule or is not based on the arm’s-length principle). Further, the Supreme Court emphasised that even though the contribution by the partners was an important factor for the achievement of carried interest, carried interest was also a result of other factors, such as the persons working in the relevant portfolio companies and market developments.
IV OUTLOOK

The Norwegian private equity sector has gone through significant changes between 2014 and the present. In 2014, the AIFMD was transposed into Norwegian law. Before that, both management and marketing of private equity funds were unregulated. Compliance practices were purely market-driven. On the other hand, the Norwegian investor market was also restricted in that both insurance companies and pension funds were strictly limited in their allocation to private equity investments. These restrictions have now been repealed following the transposition of Solvency II for insurance companies, with similar rules for Norwegian pension funds. Combined with the institutionalisation of the sector under regulation and the low interest rate climate, this may provide continued growth of private equity as an asset class.

The introduction of the AIFMD could be seen as the starting point for a more intensive regulation of the sector. Following the introduction of the AIFMD, Norwegian fund managers have also been subject to the Norwegian implementation of the EU anti-money laundering directive, FATCA/CRS, and the GDPR. Further, investors have become increasingly affected by managers establishing robust ESG policies for their investment activities. Insurers, pension funds and funds-of-funds are drivers behind this development, and managers are increasingly required to meet new ESG diligence and reporting requirements, as well as changing the interaction with portfolio companies to take into account ‘non-economic’ factors.

Outside market developments, there are three important challenges going forward for the Norwegian private equity sector. First, both in time and likely importance, Brexit may reduce market access for Norwegian fund managers to the UK market, as well as reducing the overall fundraising capability of placement agents currently headquartered in the City. We expect the market to adapt quite quickly, but the outcome is difficult to foresee.

Second, the Norwegian financial sector – and indirectly the investors and clients, both Norwegian and foreign – have been affected by the long and seemingly growing delay in implementing EU financial legislation in Norway. After the entry into force of the EEA Agreement in 1994, Norway generally implemented EU legislation with great assiduity. This changed following the establishment of the EU system of financial supervision in 2011 and the increasing legislative activity of the EU following the financial crisis.

The EU supervisory organisations – the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority – have partially supranational authority, and this conflicts with the principle of the EEA Agreement, whereby no sovereignty shall be relinquished by the EEA Member States. An agreement concerning the incorporation of the EU regulations establishing the European Supervisory Authorities into the EEA Agreement and integration into the EU system of financial supervision was concluded on 14 October 2014\(^7\) and approved by the Norwegian parliament in June 2016. This led to a delay in implementation of EU law passed during that time. Further, it seems the legal mechanism of the relevant agreement concerning financial supervision is labour intensive, whereas the number of legal acts and delegated legal acts adopted in the EU is inflating, even with the respite afforded on this point by Brexit diverting resources within the EU. The backlog of outstanding legislation does not seem to decrease in any significant way and it is difficult to see any clear prioritisation other than capital requirements.

In the asset management area, the regulations concerning EuVECA, EuSEF and ELTIF funds have not yet been implemented in Norway. Although these fund types do not seem to have had any resounding success in other EU countries, they may provide specific advantages under Norwegian law, as providing loans is a regulated activity in Norway. These fund types could, therefore, provide managers with greater flexibility and market opportunities in their investment activity in the unlisted markets in Norway. On 15 January 2018, the Ministry of Finance initiated a public consultation on the implementation of amendments to EU EuVECA and EuSEF and the delegated regulation under the ELTIF Regulation. None of the main regulations have entered into effect in Norway yet, and these will require an amendment to the Financial Undertakings Act to allow these funds to provide loans.

Lastly, the review of the AIFMD is expected later in 2020, after having been delayed because of Brexit. Legal reform brings an element of uncertainty. It is to be expected that Brexit and the position of third countries under the rules will affect the review. Private equity managers that have established or plan to establish funds in the Channel Islands, for example, would be sensitive to changes in this respect.
Chapter 14

POLAND

Marcin Olechowski, Wojciech Iwański and Mateusz Blocher

I GENERAL OVERVIEW

Poland is consistently one of the most desirable destinations for private equity funds investing in central and eastern Europe (CEE). The country has experienced sustained and rapid growth since the 1990s when the market economy was reinstated. As the largest and most populous country in the region, Poland is a regional leader in economic terms with robust GDP growth consistently above EU averages (in the third quarter of 2019, Poland’s annual economic growth was confirmed at 3.9 per cent). CEE countries continue to be Europe’s strongest region for GDP growth, with an average real GDP growth rate of 4.2 per cent in 2018. The World Bank projected Poland’s 2019 economic growth at 4.3 per cent on the back of investments, and private consumption. Furthermore, the World Bank’s forecast for central Europe for 2019 and 2020 is 3.7 per cent and 3.3 per cent, respectively.

In 2018, total private equity fundraising in CEE reached €1.82 billion (the strongest result in 10 years) and private equity investment reached €2.7 billion (the region’s second highest annual result to date, following a 24 per cent decrease from the previous year’s record result). In terms of private equity investment activity in 2018 within the CEE region, Poland remained the leading destination with 32 per cent of the region’s total investment value, followed by the Czech Republic (29 per cent), Hungary (13 per cent) and Romania (12 per cent). CEE venture capital funds raised €521 million, comprising 29 per cent of the total capital raised; over 60 per cent of CEE venture capital fundraising was attracted by fund managers based in Hungary and Poland. Moreover, Poland was again the region’s largest market for exits in 2018, accounting for 52 per cent of the total value of divestment at the historic amount of €575 million.

1 Marcin Olechowski is a partner, Wojciech Iwański is a senior counsel and Mateusz Blocher is a senior associate at Sołtysiński Kawecki & Slezak.
2 Source: Central Statistical Office of Poland. In 2018, GDP growth in the European Union amounted to 2 per cent, while in Poland it reached 5.1 per cent (Eurostat, ‘Real GDP growth rate – volume, 2018’).
3 Own calculations based on Eurostat, ‘Real GDP growth rate – volume, 2018’. For calculation purposes, CEE countries include Poland, Estonia, Latvia, Lithuania, the Czech Republic, Slovakia, Hungary and Slovenia.
In 2018, CEE private equity investment measured as a percentage of the region’s GDP decreased from 0.241 per cent in 2017 to 0.171 per cent in 2018, and, although it remained below the European average of 0.472 per cent, Poland showed results above the CEE regional average.7

CEE buyout investments continued to dominate, reaching €1.9 billion in 2018. This was the second-highest ever level of annual buyout value in the CEE region, following a 34 per cent decrease from 2017’s record result. Meanwhile, buyout investments across Europe increased 10 per cent year-on-year to €58.8 billion, the highest level since 2008. The number of companies receiving buyout funding in the CEE region was 45 in 2018, up from 41 in 2017.8

Importantly, despite its sustained growth, the Polish private equity market still remains underdeveloped in comparison with Scandinavian or western European countries, which means that Poland still has high growth potential.

II LEGAL FRAMEWORK FOR FUNDRAISING

Poland has an established and original legal framework permitting the operation of regulated private equity investment vehicles, in particular those in the form of ‘undertakings for collective investment in transferable securities’ (UCITS)9 investment funds and non-UCITS investment funds. The establishment and operation of such funds and of their managers are regulated under the 2004 Act on Investment Funds and on Management of Alternative Investment Funds (IFA).

Moreover, following the entry into force on 4 June 2016 of the 2016 Act Amending the Act on Investment Funds and Certain Other Acts, there is an established legal framework for the new category of investment vehicles – namely alternative investment companies (ASIs) – deemed alternative investment funds (AIFs) under the EU Alternative Investment Fund Managers Directive (AIFMD).10 ASIs are generally non-regulated investment vehicles, in the form of ‘ordinary’ commercial companies or partnerships, governed by the applicable rules of the Commercial Companies Code.

In 2019, key changes in the IFA included: (1) mandatory dematerialisation of investment certificates; (2) general regulation of target-date investment funds (amendments related to employee capital plans (PPK) – see Section IV); and (3) necessary adjustments to the new public offering framework under the Prospectus Regulation11 and Directive (EU) 2017/82812 on the encouragement of long-term shareholder engagement. Additionally, a number of secondary legal acts regulating terms of conduct were issued, dealing with, inter alia, the

7 ibid.
8 ibid.
manner, mode and conditions of operation of investment fund companies and the maximum remuneration of a permanent establishment for the management of an open-ended investment fund (FIO) or a specialised open-ended investment fund (SFIO).

i. Non-UCITS investment funds (closed-ended investment funds and SFIOs)

Polish law provides for two types of non-UCITS investment funds: closed-ended investment funds (FIZs) and SFIOs, both managed by an external and regulated investment fund management company (TFI). These funds are of a specific legal nature that cannot be unambiguously qualified from the perspective of usual EU investment fund classifications (corporate, contractual or trust types of funds). Like corporate entities, Polish investment funds have a separate legal personality and governing bodies. On the other hand, they are strictly distinguished from typical commercial companies.

The IFA allows both an FIZ and an SFIO (provided it applies the principles and investment limits of an FIZ) to be established specifically as a ‘non-public assets fund’ (NPA fund) investing at least 80 per cent of its assets in assets other than (1) securities offered in a public offer, except for securities that are subject to a public offer that does not require a prospectus to be drawn up; (2) securities admitted to trading on a regulated market, unless they are the subject of a public offer that requires a prospectus, or unless the admission takes place after the purchase of the securities by the fund; and (3) money market instruments, unless they have been issued by private companies whose shares are held in the fund’s investment portfolio. Such NPA funds also benefit from a slightly lighter regulatory regime than other types of funds.

FIZs

FIZs are often used as ‘private’ investment vehicles designed to enjoy various legal benefits (inter alia, tax benefits) by one or more investors (‘dedicated’ funds). To date, this practice appears to be accepted by the Polish financial services regulator – the Financial Supervision Authority (KNF) – which has publicly acknowledged that strict supervision of FIZs is unnecessary because FIZs are usually used by qualified investors.

An FIZ structure provides investors and TFIs with relatively broad flexibility in structuring the terms of their cooperation. At the same time, investing through an FIZ is subject to a number of statutory limitations or obligations. It is advisable to pre-agree, in particular, the following issues with the managing TFI before or during establishment of the FIZ.

Payment for certificates

As a rule, investment certificates issued to the investor should be paid for in cash. However, the IFA provides for certain limited possibilities for in-kind contributions (e.g., with transferable securities).

Limited scope of the FIZ’s permitted investments

The IFA sets out a closed list of investments that could be made by an FIZ (inter alia, securities, shares in limited liability companies (which, under Polish law, are not securities) and non-standardised derivatives. Under certain conditions, an FIZ may also invest in real estate.

The IFA expressly states that in respect of foreign instruments, their qualification as securities should be based on the legislation applicable to the company issuing the securities.
Furthermore, the instruments acquired by or contributed to the FIZ have to meet the criteria of transferability. Consequently, an FIZ may not become a partner in most Polish or foreign law partnerships (unless they issue transferable securities, such as the Luxembourg SCSp).

**Type of investment certificates**

FIZs may issue publicly and non-publicly traded investment certificates qualified as transferable securities under Directive 2014/65/EU on markets in financial instruments (MiFID II). In most cases, private equity investors choose non-publicly traded certificates, which affords them flexibility and eliminates additional regulatory duties. Until recently, the distinction between publicly and non-publicly traded investment certificates was based simply on the number of investors to whom certificates would be offered (non-public certificates could be issued if there were fewer than 150 investors). Currently, IFA refers to the definition provided in Article 2(d) of the Prospectus Regulation, which stipulates that ‘offer of securities to the public’ means a communication addressed to the public in any form and by any means, providing sufficient information about the terms of the offer and the securities to be offered to enable an investor to decide to purchase or subscribe to those securities. As of 1 July 2019, the certificates must be dematerialised and each issue requires the engagement of an agent.

**Diversification of investments**

To reduce the investment risk, the IFA requires, inter alia, that the aggregate of shares in one entity cannot represent more than 20 per cent of the value of an FIZ’s assets. An FIZ is legally obliged to adjust its portfolio to the statutory limits within one year of its registration, subject to the possible imposition of sanctions on the TFI by the KNF.

In the case of an FIZ operating as a private equity fund, this adjustment period is extended to three years. On the basis of certain further exceptions related to FIZs that have been established for a specified time, Polish TFIs are in a position to prolong the transition period for up to six years (or even to roll it over continually).

**Management**

Investors’ influence on the management of the FIZ (including the exercise of rights over the assets held by the FIZ) is limited. This is because the TFI, as a third-party entity, manages the FIZ and represents it in relation to third parties because the FIZ does not have its own management board (as in the case of ‘regular’ companies). The management of an FIZ may be assigned by the TFI only to a third party being a qualified investment entity, bank or other entity specified by the IFA and authorised by the KNF (or a similar authority within the EU) to manage investment funds.

Investors’ rights are exercised through participation in FIZ’s investors’ meetings, adopting resolutions in respect of the most crucial issues related to the operation of the FIZ (its liquidation, issuance of new investment certificates, etc.). The statutes of the FIZ may broaden the investors’ meeting authority to granting consent in respect of particular actions; however, actions taken in breach of those consent requirements are legally valid.

If there are at least three investors in an FIZ, its statutes may provide for a board of investors. The board of investors acts as a supervisory body and monitors the implementation of the fund’s investment goal and its investment policy, as well as the application of investment limits. Within the scope of the board’s responsibilities, the members of the
board have access to the fund’s books and documents, and the right to demand explanations from the management company. The statutes of an FIZ may broaden the powers of the board of investors.

**Distributions**

Generally, all distributions to investors from an FIZ’s assets result from redemption of their investment certificates. Distribution of profit is an extraordinary case, mainly reserved for FIZs operating as NPA funds and resulting from the direct sale of an FIZ’s assets. Rules of redemption of certificates and distribution of profit should be specified in the FIZ’s statutes.

**SFIOs**

SFIOs are not as popular a form of private equity fund as FIZs. The SFIO is a type of FIO issuing participation units (financial instruments not qualified as securities), and its statutes may restrict participation in the fund only to certain categories of entities (i.e., legal persons, organisational units without legal personality or natural persons). Moreover, natural persons must make a one-off payment to the fund of an amount not lower than the zloty equivalent of €40,000. The statutes of an SFIO may also specify further conditions of eligibility.

SFIOs applying the investment principles and investment limits of an FIZ may benefit from the special rules applicable to NPA funds (in particular, a longer deadline for diversification of assets and limited possibilities for profit distribution). At the same time, the NPA fund would still be subject to the less flexible principles of operation and regulatory regime of an FIO, making this form less attractive to private equity investors.

**Commercial companies**

**Polish fundraising legal framework**

Since the implementation of the AIFMD in Poland (which became fully effective in mid-2017), commercial companies used as investment vehicles are classified as ASIs. ASIs are subject to a regulatory regime not unlike that applicable to other AIFs (i.e., investment funds), including an obligation imposed on the alternative investment company manager (ZASI) to enter into an agreement for the performance of depositary functions with a depositary.

A ZASI cannot engage in any business activity other than ASI or AIF management. A ZASI is quite strictly regulated as to its corporate structure, the qualifications of its directors and its applied remuneration policy. Certain capital requirements are applicable to a ZASI, particularly in respect of its own capital. Transfers of significant batches of shares in a ZASI are also subject to certain restrictions and notification obligations. Outsourcing of ZASI activities is permitted, albeit subject to notification obligation or authorisation by the KNF (depending on the scope of the outsourcing). Regulations pertaining to a ZASI are not applicable to a company managing an ASI whose investors (i.e., its limited partners) are members of the same capital group as the managing company, provided that none of those investors is itself an ASI or EU-AIF.

Consequently, the list of non-UCITS-regulated investment vehicles currently includes the following legal forms.
Importantly, an ASI has to be incorporated (organised) and registered from scratch with the intention of becoming an ASI (an existing company cannot 'transform' or 'evolve' into an ASI).

**Limited partnership**

A limited partnership combines the features of a typical partnership and a commercial company. It must be established and conducted by at least two entities (natural persons, legal persons or organisational units without legal personality), with at least one partner – the general partner – bearing unlimited liability towards creditors for obligations of the partnership and at least one partner – the limited partner – having only limited liability and acting as an investor.

A limited partnership that is an ASI has only one general partner, namely a capital company or an European company, with its registered office in Poland or – in some cases – a non-EU Member State. This general partner is the relevant ZASI and must either be authorised by the KNF or – in the case of relatively small-scale operations – entered into the relevant ZASI register. The relevant ZASI is obliged to manage the affairs of the ASI, including at least the management of its portfolio and risk. A single ZASI acting as a general partner may manage more than one ASI in the form of a limited partnership (or a partnership limited by shares (SKA) – see below).

Importantly, limited partnerships are tax transparent. Although they are not, technically, legal persons, they possess a legal, judicial and procedural capacity and may in their own name acquire rights, including ownership of immovable property and other rights in rem, incur obligations, sue and be sued.

The limited partner is only liable up to the value of its contribution to the limited partnership. On the contrary, the liability of the general partner is unlimited. The general partner holds the liability of all assets severally with the other general partners, and with the limited partnership itself.

A limited partnership is established by way of a partnership deed in the form of a notarial deed, signed by all general partners and registration in the National Court Register. No minimum capital is required.

As a rule, all matters that exceed the ordinary scope of a limited partnership’s business require the consent of the limited partner, unless the partnership deed provides otherwise. Consequently, investors should make sure that their rights under the deed have been stipulated in a satisfactory way. Furthermore, in accordance with the general rules governing limited partnerships, a limited partner has a right to participate in the partnership’s profit in relevant proportion to its actual contribution to the partnership. However, the deed may stipulate otherwise, and investors should certainly consider the scope of the partnership deed in that respect.
**Partnership limited by shares**

An SKA structure combines the elements of a limited partnership and a joint-stock company, making it the most composite type of partnership in Poland. Like the limited partnership, the SKA has no legal personality, but it has legal, judicial and procedural capacity, which means that it may acquire rights and incur obligations on its own behalf (e.g., under agreements), as well as have legal standing in court.

An SKA is established by at least one general partner and one shareholder (the general partner and the shareholder may be either natural persons, legal persons or organisational units without legal personality). As an SKA is an ASI, it is no different from a legal partnership as regards its sole general partner, which must be a ZASI.

As in the case of a limited partnership, the general partner’s liability for the SKA’s obligations is unlimited. The liability is joint and several among the general partners and subsidiaries with regard to the SKA. The shareholders do not bear any liability for the SKA’s obligations.

As is the case with a limited partnership, an SKA is required to be entered into the National Court Register. The statutes should specify the value of share capital in an amount of at least 50,000 zlotys. The share capital consists only of the contributions made by the shareholders (or general partners in cases where the general partner is simultaneously a shareholder).

In respect of the shareholder’s economic rights, the shareholder should ensure its right to participate in the profit of the SKA in proportion to the contributions they have made (i.e., at least proportionally to the value of their contributions). It is possible to establish preference shares with regard to the right to dividend of up to 150 per cent of the dividend designated to non-preference shares. To increase the attractiveness and legal certainty of the SKA, the SKA’s statute may provide that each share taken up or acquired by a shareholder (investor) will give the right to more than one vote (with a maximum of two votes per share). Finally, it is possible to establish preference shares with regard to the distribution of the SKA’s assets in the event of its liquidation.

The SKA’s statutes may also provide for a supervisory board appointed by the shareholders.

**Limited liability company**

A limited liability company (Sp. z o.o.) is a simplified form of a capital company. It has legal personality and may be established by any number of shareholders, even by an individual shareholder (except a single limited liability company with only one shareholder). Shareholders are not liable for the company’s obligations. The minimum share capital is 5,000 zlotys.

The articles of association must be executed in the form of a deed. After all contributions indicated in the articles of association are made, the management board (and in some cases also the supervisory board or the audit committee) is appointed, and the company is entered into the National Court Register.

Rights and obligations of the shareholders are, as a rule, determined in the articles of association. Polish law allows a wide array of individual rights and obligations that can be granted to or imposed on the shareholders of an Sp. z o.o. Basic shareholders’ rights include voting rights and participation in the company’s profits.

If the Sp. z o.o. is used as an investment vehicle, it constitutes an ASI, and as such is subject to the regulatory framework applicable to limited partnerships and SKAs described earlier. However, unlike the latter two structures, an ASI that is a limited liability company is its own ZASI and cannot engage in any business activity other than management of its own investment activity. In particular, it cannot act as a ZASI for other ASIs (in the form of a limited partnership or an SKA).
Joint-stock company

A joint-stock company (SA) is the model capital company in the Polish legal system. The company is a legal person and may be established by any number of shareholders, even an individual shareholder (except a single limited liability company with only one shareholder). Shareholders are not liable for the company’s obligations. Minimum share capital is 100,000 zlotys and the value of share capital must be expressly specified in the statutes.

For an SA to be established, the statutes (in the form of a deed) must be signed by all original shareholders, who in turn must take up all shares in the company. Additionally, two obligatory corporate bodies (the management board and the supervisory board) must be established.

Rights and duties of shareholders in an SA are similar to those described above in the context of SKAs. This also applies to possible additional rights vested with the general assembly.

If the SA is used as an investment vehicle, it constitutes an ASI, which is at the same time its own ZASI. Importantly, however, an ASI may not operate as a simple joint-stock company, which is a recently enacted type of simplified (less regulated) SA.

iii Solicitation

As a rule, distribution of securities (investment certificates in an FIZ and shares in an SKA or SA) constitutes regulated services and is restricted to investment firms. The applicable distribution rules and the scope of mandatory disclosure are in that case subject to Poland’s local implementation regime for MiFID, including mandatory adequacy and appropriateness tests. However, if the investor is qualified as a professional or an eligible counterparty for MiFID purposes, MiFID duties are considerably limited.

It should be noted that pursuing activity of this type without the required permit could face criminal liability. If a criminal investigation is triggered by the actions of the KNF, the identity of the suspected entity is immediately disclosed on the KNF website.

Distribution of units in SFIOs is subject to the special legal regime of the IFA and its secondary legislation. Generally, such distribution may be entrusted both to regulated entities (banks, other investment firms, etc.) or non-regulated service providers, with the restriction that they have received a suitable permit issued by the KNF. The investor’s orders related to the purchase and redemption of the units may be made through natural persons who cooperate with the above-mentioned distributors on the basis of an agency agreement. Such natural persons may not receive payments designated to buy units or transfer redemption proceeds. Distributors are liable for the actions performed by their agents.

The distribution of participation interests in Polish limited companies, as well as the limited partner’s interests (neither of which qualifies as securities), are not subject to any specific legal framework.

Private equity investors could, in particular cases, be qualified as consumers. Business-to-consumer relationships fall under the applicable restrictions contained in the consumer law. While the Polish consumer protection requirements are generally in line with the applicable EU framework, the policy regarding their enforcement by the local consumer protection authorities and courts is relatively restrictive. Moreover, any marketing communication addressed to Polish consumers should always be drafted in a clear and precise manner so as not to confuse consumers. In addition, as a rule, under Polish consumer protection law, Polish must be used for all documents related to services provided to consumer clients residing in Poland.
**iv Fiduciary duties**

Pursuant to the IFA, an investment fund (whether an FIZ or an SFIO) must conduct its operations with due regard to the interests of the investor, and in keeping with the investment risk mitigation rules set out by the IFA. A TFI and the fund’s depositary are also legally obliged to act independently and in the interest of investors.

If a TFI’s actions taken in relation to the management of the fund are considered to be in breach of investors’ interests, the TFI (and, arguably, the depositary) would be subject to quite restrictive regulatory sanctions imposed by the KNF.

Depositaries are obliged not only to keep a given fund’s assets and maintain its register, but also to monitor related cash flows. The depositary has to verify whether the assets are stored in duly maintained accounts (in particular, whether the accounts are maintained by authorised entities) and whether the fund actually holds rights arising from non-equity instruments entered into the register of its assets. The depositary also ensures that agreements related to the fund’s assets are settled without undue delay.

Additionally, depositaries are expected to act as external compliance controllers for investment funds and are obliged to conduct regular reviews of their activity in this context. They also have the right (and obligation) to sue the relevant TFI at the request of an investor for damages caused by improper conduct of the relevant investment fund. Detailed rights and obligations of depositaries are regulated by agreements concluded by specific depositaries and TFIs (such agreements are usually based on standard contract terms for a depositary agreement developed by the Custodian Bank Council of the Polish Bank Association).

In the case of commercial companies, the introduction of the ASI regulatory framework imposed a number of fiduciary duties on the relevant ZASIs (i.e., general partners of a limited partnership or an SKA, or the capital companies themselves). ZASIs are required to apply roughly the same standards as investment funds and their managers (i.e., to act in a professional and sound manner, in accordance with fair market practice, and in the best interests of the investors). Additional duties could be specified either in the partnership deed, articles of association, or statutes, or in a separate investment agreement. Legal commentators emphasise, however, that all partners and shareholders have fiduciary duties in relation to the partnership itself.

### III REGULATORY DEVELOPMENTS

**i Current regulatory framework**

The KNF is the competent authority within the meaning of the relevant EU directives. It performs integrated regulatory supervision over local financial services (banking, insurance, pension fund and financial instruments markets, including the investment funds market).

The current regulatory regime applicable to private equity investments encompasses the establishment and operation of FIZs and SFIOs, as well as their management by TFIs, as well as, operation of ASIs and their management by ZASIs.

**FIZs**

The creation of an investment fund requires:

- adoption of the FIZ’s statutes by the TFI;
- execution of an agreement with a depositary on the maintenance of a register of the fund’s assets;
c the KNF’s authorisation for the establishment of an FIZ (with the reservation outlined below);
d collection of payments in the amount stipulated in the fund’s statutes (in the case of publicly traded certificates, not less than €40,000); and
e entry in the register of investment funds.

The investment fund acquires legal personality upon its registration in the register of investment funds, which is maintained by the District Court of Warsaw. Upon registration, the management company becomes the governing body of the investment fund.

Establishment of an FIZ whose investment certificates are not publicly traded or are publicly traded but there is no prospectus requirement does not require KNF consent. In addition, the scope of KNF supervision over the operations of such a fund is considerably limited. The regulatory burden in this case is moved to supervision of the TFI.

SFIOs
The creation of SFIOs, FIOs and public FIZs requires KNF authorisation (subject to target-date investment funds, which do not require authorisation) and entry in the register of investment funds. At the same time, the SFIO is obliged to publish information prospectuses and financial statements.

TFIs
Management of investment funds (including, as a rule, distribution of their units) is reserved to TFIs regulated under the IFA and its secondary legislation. Establishment of a TFI requires a regulatory permit. A permit to act as an investment fund management company may be granted only to a joint-stock company with a registered office in Poland. The scope of the permit covers activities consisting of the establishment and management of investment funds, including intermediation in the redemption or sale and repurchase of investment funds units or certificates, representing investment funds in dealings with third parties and managing a collective portfolio of securities.

The TFI must comply with certain specific requirements, including the capital adequacy requirement and the appointment of managers complying with certain conditions. The scope of activities of the TFI must be limited to the management of funds.

The IFA provides for detailed requirements concerning the composition of TFI bodies and the rules of their appointment (e.g., duty to obtain KNF’s consent to appoint, among others, a member of the management board supervising the risk management system).

Commercial companies
The operation of a commercial company classified as an ASI triggers certain regulatory duties, which are differentiated according to the value of the investment portfolio. Apart from ZASI registration or permit requirements, if the company is to conduct itself as an ASI, one of the most important issues is that the KNF filing must be made during the commercial registration process, after the transition period discussed above. However, subsequent ‘requalification’ of a commercial company as an ASI is no longer possible.
ii Taxation

In principle, FIZs are subject to general corporate income tax (CIT), although significant sources of their income are exempt from CIT, such as dividends payable by capital companies or capital gains from disposal of shares. The latter exemption does not extend to participation in profits of tax-transparent entities (such as partnerships or their equivalents), interest payable by such entities or income derived from renting out a building under a lease agreement or an agreement of a similar nature, and also including such income derived through tax-transparent entities. In practice, this limits FIZs’ appetite for co-investments with banks (e.g., in real estate), which prefer to establish investment vehicles in the form of limited partnerships (see below) and act as limited partners.

The same rules apply to SFIOs applying the investment principles and investment limits of an FIZ.

Investors in Polish investment funds are subject to income taxation with respect to proceeds received from the funds (the standard tax rate is 19 per cent, which, in the case of foreign investors, may be reduced on the basis of applicable double-tax treaties and internal regulations).

Importantly, since 1 January 2019, ASIs’ income derived from the sale of shares in a company has been subject to a CIT exemption, which applies if the ASI holds at least 10 per cent of the shares in the company’s share capital for a period of no less than two years prior to the sale (the participation exemption). However, this exemption does not apply to the sale of shares in companies of which more than 50 per cent of their assets consist of real properties.

iii MiFID II implementation

The Polish regulatory framework has recently undergone the MiFID II implementation. MiFID II has been implemented by the Act of 1 March 2018 amending the Act on Trading in Financial instruments and Certain Other Acts (including the IFA), which entered into force on 21 April 2018. The adoption of new regulations in this regard has generally impacted the private equity investment market, particularly TFIs and distributors.

The regulatory changes brought about by the MiFID II implementation can be divided into three main streams: (1) limiting TFIs’ remuneration for the management of FIOs and SFIOs by making these dependent on the type of investment and the investment risk; (2) aligning the legal requirements for TFIs and investment firms providing certain portfolio management services; and (3) aligning the legal status of funds’ units sale-and-redemption agency services with brokerage activity (accepting and forwarding orders to purchase or sell financial instruments).

Moreover, the MiFID II implementation introduced some important changes to the fundraising regulatory regimen, such as the introduction of new mandatory information requirements in relation to investors and new obligations on clients’ asset protection.

IV OUTLOOK

The most widely debated issues in the Polish private equity market are the practical consequences of adjusting the IFA to the new public offering regulatory framework under the Prospectus Regulation (and local adjustments) and Directive (EU) 2017/828, and the impact of the pension reforms introducing PPKs. PPKs are a new form of additional pension saving. The new pension system is mandatory for employing entities and (theoretically) voluntary.
for employees. The PPK system broadly involves investment funds, as the introduction of a
PPK requires the conclusion of a PPK management contract and a number of contracts for
the operation of a PPK for employees, and these are matters that have to be dealt with by
investment funds.

Also worth mentioning are the significant changes to the IFA that took place on
1 July 2019. These changes concern the obligatory dematerialisation of certain types of
securities. The Act of 9 November 2018 has amended a series of laws, including the IFA,
to strengthen financial supervision and investor protection. In this respect, the new Act
introduced, among other things, the obligatory dematerialisation of corporate bonds,
investment certificates issued by FIZs and covered bonds, irrespective of whether or not
these securities are the subject of a public offer or intended for trading on any trading venue.
The main purpose of these changes was to increase the transparency of the identity of the
issuer and the volume of the issuance of these securities, as well as to strengthen investor
protection and flexibility.

Although discussions are still taking place regarding the shape of the market following
the 2016 implementation of the AIFMD and UCITS V directives, there is no question that
these changes to the regulatory regime put an end to the ‘explosion’ of FIZs in the Polish
market that started with the 2011 deregulation. In turn, the changes in question have given
rise to new trends within the currently existing financial structures involving FIZs.
I GENERAL OVERVIEW

Fundraising activity in Portugal has somewhat slowed its recent growth, in line with the general EU trend. Although there are limited publicly available detailed fundraising figures, some data support this claim; in particular, the increase in the number of active private equity funds grew from 1172 in 2018 to the current number of 136, which represents 16 per cent growth compared with 23 per cent growth between 2017 and 2018.

According to the information available on the website of the Portuguese Securities Market Commission (CMVM),3 there are currently 136 private equity funds, 50 private equity management companies below the alternative investment fund manager (AIFM) thresholds and three private equity management companies above the AIFM thresholds.

This increase was mainly due to the Portuguese government’s implementation of the System of Tax Incentives in Research and Business Development II (SIFIDE II). SIFIDE II is a research and development (R&D) public incentive scheme whereby companies can save corporate taxes by investing in private equity funds that invest predominantly in target Portuguese R&D companies, aiming to increase the competitiveness of companies by supporting their R&D efforts.

A trend that has also been observed in recent years is the setting up of private equity funds aimed at attracting investment from those wishing to apply for Portugal’s golden visa. Private equity funds that fulfil some legal requirements (e.g., minimum investment amount, investment policy) listed by the Portuguese Regulatory Authority become qualified for this type of investment.

There have also been several recent successful independent fundraisings by local private equity firms, such as Oxy and Vallis, who were able to attract international limited partners (LPs), and these have also contributed to the increase in the number of private equity funds.

Although there is a high number of private equity investment vehicles (mainly private equity funds), the assets under management are concentrated in five private equity players.4
The value under management in the Portuguese private equity sector in 2018 amounted to around €4.6 billion (2.3 per cent of GDP). This represents a 2.1 per cent annual growth. The assets under management in the Portuguese private equity sector in 2018 increased to €4.8 billion, maintaining the growth trend observed in previous years.

The increase of the value under management and of the assets under management came primarily from an increase in the number of private equity funds, from 95 in 2017 to 117 in 2018, as private equity funds represent 95.1 per cent of the total assets under management.

These data demonstrate that private equity funds are the preferred investment vehicle in the Portuguese private equity industry, with private equity companies predominantly assuming the role of management companies of private equity funds rather than investment vehicles with their own portfolio.

Private equity activity analysed by investment stages shows a concentration of investment activity in turnaround operations (including strategic reorientation and company recovery operations), representing around 33.5 per cent of the total investments carried out in 2018. Although less impressive in comparison with turnaround activity, expansion operations (representing 22.4 per cent of total investments) also have an important impact because of the considerable number of operations carried out and of the amounts invested.

In contrast, the venture capital stage (seed capital, start-up and early stage) continues to represent a small share of the total private equity investment (18.8 per cent). In Portugal, the seed capital stage is very small, although the number of participations and amount invested has increased.

The above data relate to 2018, as no information was available for 2019 at the time of writing.

There is no official data on the duration that a fundraising process can take. However, according to the authors’ experience, it may take six months to a year.

II LEGAL FRAMEWORK FOR FUNDRAISING

The implementation of the Alternative Investment Fund Managers Directive (AIFMD) changed the legal framework applicable to private equity activity, and this was transposed into the Portuguese legal framework by Law No. 18/2015 of 4 March 2015, as amended (the Law), which is now the primary law governing private equity activity.

According to the Law, private equity activity consists in the investment in target companies (either through equity or debt capitalisation instruments) with a high potential for development and growth, to benefit in the future from this growth and development through the future sale of those target companies.

There is no accurate distinction in Portugal between the concepts of private equity and venture capital, with these concepts being used interchangeably. Therefore, unless stated otherwise, the term ‘private equity’ in this chapter refers to private equity activity in a broader sense, comprising private equity activity in all its forms, including venture capital.

6 id., at p. 6.
7 id., at p. 13.
8 ibid.
The Law sets out two different legal regimes:

a. a legal regime for those management entities whose value of assets under management falls within the following thresholds (i.e., that fall within the scope of the AIFMD): greater than €100 million, when the corresponding assets were acquired through the use of leverage, or greater than €500 million in unleveraged assets that do not grant investors redemption rights for an initial five-year period; and

b. a legal regime for those management entities whose assets under management do not fall within the AIFMD thresholds, which reproduces the legal framework previously in force as set out in the former decree law, although with some amendments.

The legal regime referred to in item (b) is less stringent than that in item (a), as the provisions of the Law, with a view to protecting investors, set out tighter requirements regarding (1) authorisation and registration of management entities with the supervising authorities; (2) internal organisation; (3) conflicts of interest to be avoided, managed or disclosed; (4) risk management policies; (5) valuation rules; (6) remuneration policies; and (7) delegation and sub-delegation of functions to third parties.

However, the managing entities referred to in item (b) may opt to request authorisation to carry out activity as a managing entity above the AIFMD threshold (opt-in procedure) and be subject to the stricter legal framework but also able to benefit from the rights granted under the AIFMD (e.g., applicability of the EU Passport).

i Preferred jurisdictions for funds

As regards investors’ preferred choice of jurisdiction, in the authors’ experience, Portuguese investors tend to select Portuguese private equity investment vehicles whenever the investment target is located primarily in Portugal.

Private equity funds that qualify for Portugal’s golden visa and the public incentive scheme (SIFIDE II) have contributed to the increase in the number of private equity funds in Portugal and have reinforced Portugal as the choice of jurisdiction for Portuguese private equity players.

Notably, according to the available data, most investors (82.5 per cent) were Portuguese residents, among whom the legal entities stand out, although there has been an increase in the number of individuals who invested, representing 30 per cent in 2018.10

The transposition of the AIFMD into Portuguese law led to a harmonised regime governing private equity activity in Europe, avoiding asymmetries between the jurisdictions and making Portugal a more competitive jurisdiction.

ii Legal forms of private equity vehicles

The Law provides for different regulated private equity vehicles, depending on whether they fall within or outside the scope of the AIFMD, and these are outlined below.

The activities carried out by these private equity vehicles are not considered to be financial intermediation activities.

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The dynamic activity of private equity in recent years has been mainly supported by the growth of private equity funds rather than by private equity companies. This is evident in the number of private equity funds compared with the number of private equity companies registered in Portugal (136 compared with 50).\textsuperscript{11}

**Private equity vehicles outside the scope of the AIFMD**

**Private equity companies**
Private equity companies\textsuperscript{12} are limited liability companies\textsuperscript{13} incorporated with a minimum share capital of €125,000. Private equity companies are vehicles that:

- can be incorporated to directly own a portfolio of investments;
- can be incorporated with the sole purpose of managing private equity funds; or
- can combine both activities (i.e., they can directly own a portfolio of investments and manage private equity funds).

**Private equity funds**
Private equity funds\textsuperscript{14} are contractual funds managed by entities that do not surpass the thresholds set in the AIFMD: autonomous sets of assets without legal personality. Private equity funds are not at all responsible for the debts of the investors, for the debt of the entities that undertake the fund’s management, deposits and marketing or for the debts of other private equity funds. This legal form corresponds to the more commonly known ‘contractual funds’. Private equity funds have a minimum subscribed capital of €1 million.

**Private equity investors**
Private equity investors are special private equity companies mandatorily incorporated as a single shareholder limited company. Only individuals may be a sole member of private equity investors. The registration of private equity investors with the CMVM is not made public.

**Private equity vehicles within the scope of the AIFMD**

**Private equity fund management companies**
Private equity fund management companies\textsuperscript{15} are limited liability companies, incorporated with a minimum share capital of €125,000, whose scope is the management of private equity funds that fall within the scope of the AIFMD and they are not allowed to directly own a portfolio investment. Following that, these companies are subject to more demanding legal requirements, namely as regards the access necessary to carry out this activity and the companies’ operating conditions.

\begin{itemize}
\item \textsuperscript{11} Information from the CMVM website; see footnote 3.
\item \textsuperscript{12} Sociedades de capital de risco.
\item \textsuperscript{13} Sociedades anónimas.
\item \textsuperscript{14} Fundos de capital de risco.
\item \textsuperscript{15} Sociedades gestoras de fundos de capital de risco.
\end{itemize}
Private equity investment companies

Private equity investment companies are funds of a corporate nature whose purpose is direct investment in private equity, and in having their own portfolio. These companies may be externally or self-managed. If externally managed, they are managed by private equity fund management companies or by collective investment undertakings management companies. If self-managed they must have a minimum share capital of €300,000.

Private equity collective investment undertakings

Private equity collective investment undertakings are contractual funds managed by entities above the threshold set in the AIFMD, namely private equity fund management companies or collective investment undertakings management companies. The legal provisions concerning the above-mentioned private equity funds that fall outside the scope of the AIFMD are also applicable to these funds, along with more specific and demanding provisions regarding liquidity management, asset evaluation, and disclosure of information to the investors and to the CMVM.

iii Key legal terms

The relationship between investors and the private equity vehicles (i.e., the functioning and operating rules of the private equity funds) is governed by a set of rules negotiated with the investors, which in addition to the applicable legal and regulatory provisions will constitute the fund’s rules as the fund’s primary constitutive documentation.

Certain legal terms are imposed by mandatory provisions set out in the Law (to be provided in the private equity fund’s rules) and others that, although not mandatory, are typically negotiated between the investors and the private equity management entities.

The following typical key terms are worth highlighting.

a Key-man provisions: these are applicable to certain key members of the private equity fund’s management company, who are expected to devote their business time to the management of the private equity fund or the private equity company concerned; should this not be the case, several consequences may be triggered, such as the replacement of those key members or the immediate suspension of new investments, follow-on investments or divestments for which there were no binding commitments prior to the event.

b Borrowing limits of the private equity fund: according to the Law, the borrowing limits shall be set out in the fund’s rules. This is an important item decided between the investors and the management entities.

c Portfolio diversification: provisions that impose investment diversification criteria more stringently than those imposed by the Law.

d Investment restrictions: geographic limitations and limitations regarding the type of industry (e.g., prohibited industry sectors).

e Removal of the fund’s management company: provisions regarding the removal of the fund’s management company either with or without cause. Typically, ‘cause’ will include fraud, wilful misconduct, gross negligence, material breach of the fund’s legal documentation or any unauthorised change of control. As cause may be difficult to

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16 Sociedades de investimento em capital de risco.
17 Organismos de investimento em capital de risco.
prove, the negotiations tend to focus on the relevant terms that will trigger removal ‘without cause’, notably regarding relevant voting majorities, implications for management fees and the right of the management entity to eventual compensation.

Exclusivity: provisions regulating the setting up of other funds by the managing entities.

Early termination: provisions allowing for the early termination of the investment period (this is an investor protection provision). This is one of the negotiable terms that has given rise to more detailed provisions.

LP advisory committee: an advisory board composed of nominees of the investors. Their typical functions are the monitoring of conflicts of interest and taking relevant resolutions on these matters.

Change of control: provisions aiming to prevent change of control in the management entities, establishing that, in the event of an unauthorised change, an early termination of the fund, or replacement of the management entities, may occur.

Most-favoured-nation clause: provisions set out in the fund’s rules to ensure the principle of equal treatment of the investors. These provisions entitle investors to receive the same benefits as any arising for other investors through side letters.

iv Key disclosure items

Private equity entities shall submit information biannually to the CMVM regarding their investment portfolios, capital, performance, commissions, investors, the acquisition and disposal of assets, and the balance sheet and financial statements.18

Private equity entities must also disclose information to the CMVM, on a regular basis, on such matters as: the main instruments in which it is trading, main risk positions, most important concentrations of risk, total value of assets under management, and a general description of the investment strategy.

The provision of this information is integral to the CMVM’s supervisory function and important for statistical purposes.

The information to be provided to the investors on an ongoing basis is usually regulated by the fund rules, which usually stipulate that the information shall be reported quarterly. These reports usually contain consolidated information on variations in the net asset value, an overview of each of the key figures in the portfolio companies, and market comparisons.

The Law, following the AIFMD provisions, sets out more onerous disclosure requirements that must be made to investors before they invest in private equity activity, namely regarding the investment strategy and objectives, leverage, how changes in strategy may be implemented, service providers, valuation procedures, fees and expenses, risk profile, remuneration practices and policies, and a historical outline of the financial results obtained by the private equity fund.

Other key disclosure items

Private equity fund management entities shall annually submit for approval by the general meeting a statement regarding the remuneration policy of the members of their respective administrative and supervisory boards, which shall be disclosed in their annual financial statements together with information regarding the total and individual annual remuneration

18 CMVM Regulation No. 3/2015.
received by the above-mentioned directors. The requirement to set remuneration policies and practices applicable to private equity vehicle entities falling within the scope of the AIFMD has been further strengthened by the introduction to the Law of an additional provision.

v Solicitation of investors

Most commonly, solicitation is made by way of initial contact with the key investors, which is followed by a distribution of the draft of the fund rules that will govern the private equity fund. The fund rules are the primary constitutive document to be negotiated with the potential investors.

As a matter of fact, the Law expressly states that the subscription or acquisition of a private equity fund’s investment units is conditional upon being subject to that fund’s rules. As such, whenever there is a subscription, the investor must at the same time accept and agree to be subject to the fund’s rules.

Where the vehicle is a private equity fund (whether of a corporate or a contractual nature), a solicitation process by private subscription includes the negotiation of the fund’s rules and, in the case of a vehicle of a corporate nature, also the negotiation of the articles of association between the investors and the fund’s management entity. Similarly, a solicitation process by public offer entails the negotiation of the prospectus.

Portugal has been witnessing a recourse to international placement management to allow access to international LPs. However, if the solicitation is made by public offer, the general rules set out in the Portuguese Securities Code apply.

vi Fiduciary duties of management entities

When performing their management activities, the directors of management entities shall comply with the fundamental fiduciary duties set out in the applicable company law – the Portuguese Companies Code – which include the duty of care and the duty of loyalty. Portuguese law defines the duty of care standards to be observed by directors as that of a wise and orderly manager, with an understanding of the company’s business appropriate to their role. In addition, directors must have the availability and the proper technical capacity and skills to perform their relevant functions.

Furthermore, the duty of loyalty includes an obligation to act in the best interests of the company and to consider the long-term interests of the shareholders, as well as those of the company’s stakeholders who are relevant for the company’s sustainability. Additionally, this duty entails a non-competition obligation towards the company, which requires directors to place the interest of the company and its shareholders above their own.

The Law particularises the following duties for management entities:

a to refrain from entering into arrangements that may lead to a clash of interests with investors;

b to set an organisational structure and internal procedures proportional to the size and complexity of their activity;

c to perform their activities to safeguard the legitimate interests of the investors; and

d the board members of these entities must be reputable and experienced, to ensure sound and prudent management.

Moreover, in many cases the fiduciary duties are expressly set out in the constitutive documents (e.g., the fund’s rules), thereby ensuring higher standards.

III REGULATORY DEVELOPMENTS

i Regulatory oversight by the national authorities

The prudential and market conduct of the above-mentioned private equity vehicles are subject to the CMVM’s supervision. The CMVM is an independent public institution with administrative and financial autonomy.

Pursuant to the aforementioned powers of supervision granted to it, the CMVM has decision-making powers regarding the granting, or refusal, of registry or authorisation, as applicable, as well as powers to demand of private equity management entities the provision of all necessary information and documents for compliance with the legal framework of private equity activity.

Investors are not necessarily subject to CMVM supervision simply because they are private equity investors. In fact, an investor may be subject to supervision by any national authority as a result of its functions, not merely as a result of being a private equity investor (e.g., if the investor is a bank or any other credit institution, it is subject to the supervision of the Bank of Portugal).

However, the Law provides that holders of qualifying holdings in all private equity companies should comply with the conditions that ensure the sound and prudent management of those companies.

ii Registration and authorisation requirements

The Law creates two different legal regimes, one applicable to managing entities that fall outside the scope of the AIFMD and the other to those that fall within the scope of the AIFMD.

Each legal regime has different registration requirements, with the registration procedure applicable to managing entities that fall outside the scope of the AIFMD being softer than the one applicable to entities within the scope of the AIFMD (which require authorisation in advance), as summarised below.

Registration requirements applicable to managing entities that fall outside the scope of the AIFMD

The setting-up of private equity funds and commencement of activities by private equity investors and private equity companies (regardless of whether they directly own a portfolio of investments or have the sole purpose of managing private equity funds, or a combination of both activities) is conditional on having previously registered the activity with the CMVM.

However, whenever the capital is not offered to the public and the investors are qualified investors or, regardless of the type, when the minimum capital subscribed by these investors is equal to or greater than €500,000 for each investor, the setting up of a private equity fund and the commencement of activity of private equity companies and private equity investors is subject only to a requirement to notify the CMVM of the activity.
Authorisation requirements applicable to managing entities that fall within the scope of the AIFMD

The Law sets out stricter registration requirements for those management entities that fall within the scope of the AIFMD.

The commencement of activities of such management entities is subject to a prior authorisation by the CMVM. The standard of information required for this authorisation request is, in this particular case, rather extensive, requiring significant support documentation since these managing entities raise more concerns from the Community and national legislators on account of their size.

If the CMVM fails to reply to the application request within the prescribed time frame, the application is considered to have been rejected.

iii Tax regime

At the level of the funds

Private equity funds set up and operating under Portuguese law are exempt from Portuguese corporate income tax (CIT) on capital gains, dividends, interest and any other sort of income received either from Portuguese or foreign sources. This CIT exemption means private equity funds will not be able to claim foreign tax credits that might be levied on investments made abroad.

The simple reimbursement of the capital invested by the investors is not taxed.

The setting-up of a private equity fund and subsequent capital increases do not trigger stamp duty or any other sort of taxation. Depending on the type of commission charged to private equity funds, indirect taxation could be levied.

At the level of Portuguese tax-resident investors (individuals or corporations) or non-resident investors with a permanent establishment in Portugal

Income paid or made available by private equity funds (by means of distributions, redemption of fund units or by virtue of liquidation) to investors that are Portuguese tax residents, or to non-residents with a permanent establishment located in Portugal to which the units are allocated, is subject to a 10 per cent withholding tax, except in the case of investors that benefit from a general tax exemption.

Withholding tax (if any) constitutes definitive taxation of Portuguese tax-resident individual investors acting outside the scope of a commercial, industrial or agricultural activity, unless they opt to aggregate the income deriving from the participation units to global income, which is then subject to progressive personal income tax at rates of up to 48 per cent.20 If this were the case, if income distributed included dividends, only 50 per cent of the dividends would be considered for personal income tax assessment purposes.21

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20 The maximum rate of 48 per cent is applicable to income up to €80,640 (or €80,882 in accordance with the State Budget proposal for 2020, which is not yet approved), plus an additional solidarity rate of 2.5 per cent imposed on income exceeding €80,000 and up to €250,000, and of 5 per cent on income exceeding €250,000.

21 Fifty per cent of the amount of dividends included in income paid or made available by private equity funds to Portuguese tax-resident individual unitholders acting within the scope of a commercial, industrial or agricultural activity shall also be considered, provided they are included in the organised accounting regime.
For other investors, withholding tax constitutes a payment on account of the final tax liability and is levied at the following rates: (1) standard corporate income tax rate of 21 per cent, in relation to corporate entities;\(^{22}\) and (2) the general progressive personal income tax rates of up to 48 per cent,\(^{23}\) applicable to individual investors acting within the scope of a commercial, industrial or agricultural activity.

Capital gains obtained by Portuguese tax-resident investors through the sale of units in private equity funds are subject to taxation at the following rates: (1) standard corporate income tax rate of 21 per cent\(^{24}\) for corporate entities; (2) the general progressive personal income tax rates up to a maximum rate of 48 per cent\(^{25}\) for individual investors acting within the scope of a commercial, industrial or agricultural activity; and (3) a flat-rate personal income tax of 10 per cent for individual investors acting outside the scope of a commercial, industrial or agricultural activity, unless they exercise the option for aggregation.

**At the level of non-resident investors (individuals or corporations) without a permanent establishment in Portugal**

Income paid or made available by private equity funds (by means of distributions, redemption of fund units or by virtue of liquidation) to non-resident investors without a permanent establishment in Portugal, and the capital gains obtained by investors from the sale of their units, shall not be subject to withholding taxes, to the extent that (1) the unitholders are not resident in clearly more favourable tax jurisdictions,\(^{26}\) and (2) in the case of corporate entities, Portuguese residents do not hold share capital in the entity, directly or indirectly, of more than 25 per cent. When these conditions are not met, Portuguese taxation is levied at a rate of 10 per cent on both the income distributed by private equity funds and the capital gains derived from the sale of the corresponding units, except where a double-tax treaty has been entered into between Portugal and the unitholders’ state of residence granting exclusive right to tax this type of income and gains to the beneficiaries’ state of residence, in which case no Portuguese taxation is due.

Finally, investors will not be considered to have a permanent establishment in Portugal simply by virtue of having invested in the fund.

**IV OUTLOOK**

Market observers anticipate a stable or even decreasing fundraising activity from international LPs given the current grim economic outlook and the more balanced supply and demand of private equity that currently exists in Portugal. On the other hand, it is likely that the government will continue to push for policies directed at fostering the private equity market in general, and, therefore, for public funds to continue to be deployed in the near future.

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\(^{22}\) Plus municipal and state surcharges, if applicable.

\(^{23}\) See footnote 20.

\(^{24}\) See footnote 22.

\(^{25}\) See footnote 20.

\(^{26}\) As listed by Ministerial Order No. 150/2004, dated 13 February 2004, and subsequent amendments.
Chapter 16

SOUTH KOREA

Chris Chang-Hyun Song, Tae-Yong Seo, Joon Hyug Chung, Sang-Yeon Eom and Seung Hyun Dennis Cho

I GENERAL OVERVIEW

Regulations on onshore private equity (PE) funds were first introduced in South Korea in 2004 following the enactment of the Indirect Investment Asset Management Business Act. In 2009, this Act and the Securities and Exchange Act were integrated into a new law known as the Financial Investment Services and Capital Markets Act (FSCMA), which primarily regulates fundraising, formation, management and operation of private equity funds in South Korea. Since 2004, there has been a remarkable growth in the South Korean PE fund market, with the number of PE funds increasing from two in 2004 to 583 as at the end of 2018.

During the early years following the introduction of PE funds in South Korea, limited partners (LPs) were mostly financial institutions. However, as the PE fund market expanded, large pension funds such as the National Pension Service (NPS) have been actively participating as anchor investors. More recently, the number of smaller PE funds, with a commitment amount of 100 billion won or less, has been increasing, and project-based funds formed to acquire specific investment targets compose more than 70 per cent of all PE funds registered with the Financial Services Commission (FSC).

Previously, only financial institutions such as banks, securities companies and asset management companies acted as general partners (GPs); however, the number and variety of institutions acting solely as general partners has increased, and as a result, they now compose 66 per cent of the total number of GPs in South Korea.

1 Chris Chang-Hyun Song, Tae-Yong Seo, Joon Hyug Chung and Sang-Yeon Eom are partners and Seung Hyun Dennis Cho is a foreign legal consultant at Shin & Kim.
2 New technology business investment partnerships prescribed in the Specialised Credit Finance Business Act, small or medium-sized enterprises established as investment partnerships prescribed in the Support for Small and Medium Enterprise Establishment Act and new technology venture investment partnerships prescribed in the Act on Special Measures for the Promotion of Venture Businesses are similar to a venture capital fund as used in the United States and Europe, and can be considered as a private equity fund in a broader sense. For the purposes of this chapter, we discuss the private equity fund governed by the Financial Investment Services and Capital Markets Act.
The first table below indicates the number of registered PE funds in South Korea and the second table refers to the total commitment amounts and total invested amounts in recent years.4

<table>
<thead>
<tr>
<th>Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of funds</td>
<td>226</td>
<td>237</td>
<td>277</td>
<td>316</td>
<td>385</td>
<td>444</td>
<td>583</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total commitment amount (A) (x100 million won)</td>
<td>399,821</td>
<td>439,999</td>
<td>512,442</td>
<td>585,180</td>
<td>622,261</td>
<td>626,032</td>
<td>745,012</td>
</tr>
<tr>
<td>Total invested amount (B) (x100 million won)</td>
<td>210,567</td>
<td>280,844</td>
<td>317,634</td>
<td>383,903</td>
<td>435,931</td>
<td>455,353</td>
<td>557,103</td>
</tr>
<tr>
<td>Investment ratio (B)/(A)</td>
<td>52.7%</td>
<td>63.8%</td>
<td>62%</td>
<td>65.6%</td>
<td>70.1%</td>
<td>72.7%</td>
<td>74.8%</td>
</tr>
</tbody>
</table>

The table below indicates the number of PE funds, sorted by volume of commitment amounts.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total commitment amount</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>At least 300 billion won</td>
<td>45</td>
<td>47</td>
<td>51</td>
<td>57</td>
<td>53</td>
<td>48</td>
<td>51</td>
</tr>
<tr>
<td>Medium-sized</td>
<td>100 billion to 300 billion won</td>
<td>63</td>
<td>76</td>
<td>100</td>
<td>115</td>
<td>127</td>
<td>130</td>
<td>146</td>
</tr>
<tr>
<td>Small</td>
<td>Up to 100 billion won</td>
<td>118</td>
<td>114</td>
<td>126</td>
<td>144</td>
<td>203</td>
<td>266</td>
<td>386</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>226</td>
<td>237</td>
<td>277</td>
<td>316</td>
<td>383</td>
<td>444</td>
<td>583</td>
</tr>
</tbody>
</table>

The table below indicates the number of institutions acting solely as GPs (independent GPs) and the number of financial institutions participating as GPs (FI GPs).

<table>
<thead>
<tr>
<th>Year</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent GPs</td>
<td>94 (56.3%)</td>
<td>115 (60.5%)</td>
<td>138 (66%)</td>
<td>152 (65.5%)</td>
</tr>
<tr>
<td>FI GPs</td>
<td>73 (43.7%)</td>
<td>75 (39.5%)</td>
<td>71 (34%)</td>
<td>80 (34.5%)</td>
</tr>
<tr>
<td>Total</td>
<td>167</td>
<td>190</td>
<td>209</td>
<td>232</td>
</tr>
</tbody>
</table>

In a statement dated September 2018, the FSC announced its plan to integrate two categories of private placement fund – specialised investment private fund (hedge fund) and management participation private fund (PE fund) – into a single regime, and as such, we expect fundamental changes to the regulation and operation of the PE fund market in South Korea. The major changes to the FSCMA announced by the FSC are discussed in detail in Section III.

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II LEGAL FRAMEWORK FOR FUNDRAISING

i Incorporation of a PE fund

The legal form of a PE fund in South Korea is a corporate vehicle, limited company under the Korean Commercial Code (KCC), which is similar to a limited partnership in US law. The formation of a PE fund requires a minimum of one GP with unlimited liability and one LP with limited liability. In practice, nearly all GPs act as managing partners of PE funds.

The qualification requirements for an LP are as follows:

a professional investors as prescribed in the Enforcement Decree of the FSCMA (mostly financial institutions and pension funds); or

b individuals, corporations or other organisations investing at least 300 million won (100 million won for an executive officer of a GP or a fund manager) in a PE fund.

As PE funds are also categorised as private placement funds, the total number of members must be 49 or below. A filing with respect to the incorporation of a PE fund must be made to the FSC within two weeks of the registration of its incorporation with the court.

ii Registration requirements for GPs

When the PE fund regime was first introduced in South Korea in 2004, there was no statutory licence or qualification requirement for a GP. In 2013, the FSCMA was amended to include certain requirements for an entity contemplating becoming a GP in South Korea. To register as a GP, the following conditions must be satisfied:

a a minimum capital of 100 million won;

b compliance by each executive officer of the GP with Article 5 of the Act on Corporate Governance of Financial Companies;

c employment of at least two individual fund managers;

d setting up of an internal compliance policy to identify, assess and manage the possibility of conflicts of interest; and

e maintaining sound financial standing and social credibility as prescribed in the Enforcement Decree of the FSCMA.

iii PE fund asset management methods

The asset classes that a Korean PE fund is permitted to acquire are narrow. The FSCMA requires a PE fund to participate in the management of its portfolio companies and to manage its assets in the following manner:

a it must acquire 10 per cent or more of the issued and outstanding shares with voting rights in a target company;

b if an investment is being made in relation to less than 10 per cent of the issued and outstanding shares or the total capital amount, the investment must allow the exercise of de facto control over the target company’s material management issues.

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5 In practice, however, it is required to have at least two LPs, as a PE fund is subject to dissolution if the number of LPs is less than two. This does not apply where a pension fund becomes the sole LP of a PE fund.

6 In practice, retaining a right to appoint one or more directors of the target company is deemed as exercising a de facto control over the target company’s material management issues.
the investment must be in equity-linked bonds (i.e., convertible bonds (CBs), bonds with warrants (BWs) and exchangeable bonds (EBs)) issued by the target company for the purpose of point (a) or (b), above;

derivatives transactions can be carried out for the purpose of mitigating risks related to investment in securities issued by the target company and fluctuation in currency exchange rates;

investments can be made in securities issued by an investment company for infrastructure purposes in accordance with the Act on Public-Private Partnerships in Infrastructure; and

investments can be made in securities issued by a special purpose company (SPC).

Further, the following restrictions apply to PE funds’ management of investment assets under the FSCMA:

a PE fund is required to invest at least 50 per cent of its assets in the manner stipulated in points (a), (b), (e) and (f), above;

a PE fund must retain the securities acquired in the manner stipulated in points (a), (b) or (c), above, for at least six months and must not dispose of them within a six-month period;

a PE fund is not allowed to invest in the shares of a foreign corporation if 30 per cent or more of assets held by such foreign corporation and its subsidiaries (out of their total assets) is located in South Korea; and

a PE fund is permitted to incur an indebtedness if (1) it is unavoidable for repaying a contribution amount to a departing member, (2) there is a temporary shortage in operating costs, or (3) there is a temporary shortage of funds for an investment in a target company, provided that the total indebtedness may not exceed 10 per cent of the net asset of the PE fund.

If a PE fund enters into a transaction where it is permitted to exercise a put option for its shares of the target company at an exercise price calculated based on the PE fund’s internal rate of return (IRR) during the investment period on a condition that the target company does not satisfy its initial public offering obligation within the agreed period to protect the PE fund’s invested capital and the IRR, the FSC has held that the PE fund’s investment in the target company is interpreted as a de facto loan, and further held that it was in violation of the PE fund’s asset management method under the FSCMA.

Since the first introduction of the PE fund regime in South Korea, there have been concerns that chaebols (large, family run conglomerates) would be likely to exploit the PE fund scheme for the purpose of expanding their businesses or unfairly supporting their affiliates. The FSCMA includes the following provisions to prevent potential abuse of the PE fund by chaebols.

If a PE fund that is an affiliate of a ‘business group subject to limitations on cross shareholding’ (a ‘restricted business group’) as prescribed in the Monopoly Regulation and Fair Trade Act, or a PE fund whose GP is an affiliate of a restricted business group, acquires a target company as an affiliate, it must sell its shares in the target company to a third party other than its affiliate.

A PE fund that is an affiliate of a restricted business group or a PE fund whose GP is an affiliate of a restricted business group is prohibited from acquiring equity securities of an affiliate.
iv Incorporation of an SPC

The FSCMA allows an investment by a PE fund by way of incorporating an SPC. Requirements for establishing and operation of an SPC are as follows:

a. the SPC is a joint stock company or a limited company under the KCC;
b. the SPC is in compliance with the provisions related to a PE fund’s asset management method in the FSCMA;
c. a shareholder or a member of the SPC is the PE fund, an executive officer of the target company, the major shareholder or a person designated by the Enforcement Decree to the FSCMA, provided that the PE fund’s shareholding ratio in the SPC is 50 per cent or above;
d. the sum of (1) the number of shareholders of the SPC or the number of members of the PE fund and (2) the number of non-PE fund shareholders or members, is 49 or below; and

e. the SPC does not employ a full-time executive officer or staff and does not maintain a place of business other than a head office.

An SPC may borrow up to 300 per cent of its net assets and, therefore, a PE fund may make a leveraged investment in a target company by way of incorporating an SPC.

v Monitoring of PE fund by regulators

In South Korea, the FSC and the Financial Supervisory Service, the executive body of the FSC, oversee PE funds and GPs managing the PE funds. If an onshore PE fund or a GP violates the relevant laws, the FSC has the power to do the following:

a. cancel its registration;
b. suspend all or part of its business;
c. demand that the PE fund dismiss, suspend from duty or issue a warning or admonition with regard to its officers;
d. issue a warning or admonition against the PE fund;
e. demand that the PE fund dismiss, suspend from duty, reduce salaries of, reprimand, or issue warnings or admonitions to, its employees; or

f. issue a remedial order or demand certain measures for compensation of the damages incurred by its investors.

III REGULATORY DEVELOPMENTS

The FSCMA provides the general legal framework for the PE fund regime, including incorporation of a PE fund, asset management and requirements of GPs and LPs, among other matters. A meeting of members of a PE fund, liquidation of a PE fund and other business affairs that are not governed by the FSCMA are covered under the KCC. Since the inception of the PE fund regulations, there have not been many changes from a regulatory perspective; however, there were significant amendments to the PE fund-related provisions of the FSCMA in 2015. Some of the important changes are noted below.

a. Previously, registration with the FSC was required prior to the incorporation of a PE fund. This has been changed to allow a filing with the FSC after the incorporation of the fund.
At the end of 2016, the amendment to the FSCMA introduced PE funds specifically designed for the purpose of investing in start-up companies and venture companies (start-up and venture PE fund). The start-up and venture PE fund enjoys certain corporate tax benefits if it invests 50 per cent or more of its assets in a venture business or a technology and innovation-driven small or medium-sized enterprise within two years of its incorporation.

Under the current FSCMA, private placement funds in South Korea can only be categorised as hedge funds or PE funds, and can be largely distinguished as follows.

a A hedge fund may invest in securities, loans, derivatives and real estate assets, whereas a PE fund’s investment is limited to equity securities or equity-linked bonds, such as CBs, BWs or EBs, further provided that the PE fund acquires shares with 10 per cent or more of voting rights through such investment (or alternatively, the PE fund can be granted with the right to appoint one or more director of the target company as a condition to its investment). On the other hand, a hedge fund is prohibited from acquiring shares with voting rights of 10 per cent or more when making investments in equity securities or equity-linked bonds.

b A hedge fund is allowed to incur an indebtedness of up to 400 per cent of its net assets, whereas a PE fund is generally prohibited from incurring an indebtedness (aside from a few exceptions) but may incur up to 300 per cent of the net assets of an SPC if the PE fund is making investment via the SPC.

c There are stricter requirements for fund managers of hedge funds in terms of capital requirements, professional managers and major shareholder requirements when compared with those of PE funds.

In September 2018, the FSC announced that there would be an amendment to the FSCMA to reform the private placement fund scheme in South Korea. Under the newly amended FSCMA, the FSC will only allow a single type of private placement fund that will integrate the hedge fund and PE fund schemes. According to the FSC’s statement, the major changes will be as follows.

a The integrated private placement fund (‘integrated fund’) will be able to invest in shares, loans, derivatives or real estate assets. Notably in relation to the securities investment, there will no longer be any minimum or maximum limitation on the shareholding in a portfolio company.

b The integrated fund will be permitted to incur indebtedness of up to 400 per cent of its net assets.

c The fund manager of the integrated fund will be required to comply with the current requirements for a hedge fund manager.
GPs of existing PE funds that cannot comply with the current requirements for a hedge fund manager will be able to manage an integrated fund in which only institutional investors (as prescribed in the FSCMA) participate as LPs.

Previously, the standard of distinguishing a public offering fund and a private placement fund was whether a solicitation of offer was made to 50 or more parties; in the newly amended FSCMA, the threshold will be whether 50 or more parties have actually accepted the offer.

At the time of writing, the proposed amendment to the FSCMA is pending at the National Assembly.

IV OUTLOOK

Since the first introduction of the onshore PE fund scheme in 2004, there has been a continuous growth of the PE fund market in South Korea. In particular, there has been a remarkable expansion in the market in the past decade, and, in fact, PE funds have been leading South Korea’s M&A sector for many years. It is expected that the South Korean PE fund market will continue to grow in the near future while large pension funds, such as the NPS, will continue to play the role of anchor investor to large PE funds.

One of the current features of the South Korean PE fund market is that secondary PE funds are not yet very active compared with in seasoned PE markets such as the United States and the European Union. This is mainly because a few large pension funds tend to widely allocate their investments to various PE funds, which results in overlapping of LPs in many PE funds. However, the need for secondary PE funds has been developing and it is expected that the number of secondary PE funds will increase.

Additionally, it is expected that the private placement fund market will grow rapidly once the above-mentioned proposed amendment to the FSCMA expands the scope of investment methods and asset classes, and eases the standard of being recognised as ‘private placement’. Existing GPs will have to decide whether they should increase the size of their capital and professional manpower to continue their business as fund managers of integrated funds under the new regime, or whether they should maintain the current capital volume and manpower, and maintain their status as fund managers for private placement funds for institutional investors.
Chapter 17

SWITZERLAND

Fedor Poskriakov, Maria Chiriaeva and Isy Isaac Sakkal

I GENERAL OVERVIEW

An aggregate amount of €2.374 billion was raised by private equity funds in Switzerland during 2018. While this figure is significantly higher than the amount raised in 2016 (€704 million) and in 2015 (€1.28 billion), it is below the amount raised in 2017 (€4.43 billion). About half of the fundraising in 2018 was related to buyout transactions. Large institutional investors such as pension funds and insurance companies remained the decisive driving force for the private equity sector. A substantial increase of the amounts invested by funds occurred, from €154 million in 2017 to €235 million in 2018. The Swiss regulator, together with the Swiss Funds and Asset Management Association (SFAMA) and the Swiss Private Equity and Corporate Finance Association (SECA), are keen on aligning the Swiss legal framework with the developments in the European Union and are actively working to promote Switzerland as an attractive fundraising location.

In recent years, innovation has been at the centre of attention across many industries. In 2019, Switzerland was ranked in top position, for the ninth consecutive year, as the world leader for innovation by the Global Innovation Index. According to the Swiss Venture Capital Report of 2019, financing rounds increased by 31.4 per cent in 2018 from 175 in 2016 to 230 in 2018, while the total amount of money invested in Swiss start-ups increased by 31.8 per cent, from 939 million Swiss francs in 2017 to 1.24 billion Swiss francs in 2018. In particular, seed financing rose more than fourfold from under 20 million Swiss francs to approximately 80 million Swiss francs. The information and communications technology and fintech sector replaced life sciences as the largest Swiss venture capital sector with a total of 685 million Swiss francs invested. Over the past five years, the financing volume for start-ups in the technology sector has increased more than sevenfold. For the fintech industry, the decisive considerations remain financing and fundraising.

The venture capital market growth trend is likely to continue. In 2019, the launching of a fund by the Swiss Entrepreneurs Foundation was approved by the Swiss Financial Market

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1 Fedor Poskriakov is a partner, Maria Chiriaeva is a senior associate and Isy Isaac Sakkal is an associate at Lenz & Staehelin.
3 ibid.
4 ibid.
6 ibid.
7 ibid.
Supervisory Authority (FINMA). The fund concluded a first round of funding, raising a total of 193 million Swiss francs. Although this is below the initial targeted amount of 500 million Swiss francs, it is a first step aimed at supporting Swiss start-ups. Venture capital investments in start-ups are popular with private equity investors seeking to take advantage of favourable borrowing conditions and negative interest rates. Correlatively, and as a result of, inter alia, the Ordinance Against Excessive Remuneration in Listed Companies, various obligations have increased the cost of investment in public companies so that for many investors an investment in start-ups has become more attractive.

II LEGAL FRAMEWORK FOR FUNDRAISING

Fundraising in or from Switzerland through the use of collective investment schemes (CISs) is mostly governed by the Collective Investment Schemes Act of 23 June 2006 (CISA) and its implementing ordinances (CISO and FINMA-CISO) at product level, respectively, and the new Swiss Federal Financial Services Act (FinSA) at service level (point of sale regulations). Switzerland is not a member state of the European Union and, therefore, the EU Alternative Investment Funds Managers Directive (AIFMD) does not apply. That being said, the 2013 revision of the CISA, among other things, mostly aligned the Swiss legal framework with the third-country requirements of the AIFMD, in a bid ultimately to benefit from the extension of passporting to third countries, if and when the same will become available, if at all.

A number of significant changes to the CISA and its implementing ordinance entered into force on 1 January 2020 as part of the overhaul of the Swiss financial services regulatory regime including the FinSA and the Swiss Federal Financial Institutions Act (FinIA). While the purpose of the FinIA is to provide a new legal framework governing all financial institutions, the objective of the FinSA is to regulate financial services, whether provided in Switzerland or to Swiss clients on a cross-border basis. Both the FinSA and FinIA are complemented by implementing ordinances, namely the Financial Services Ordinance and the Financial Institution Ordinance. The new statutes are largely inspired by the EU financial markets and services regulations (the Markets in Financial Instruments Directive (MiFID), the Prospectus Directive and the Packaged Retail and Insurance-based Investment Products Regulation) and provide, among other changes, for:

\[ a \] an abolition of licensing requirement for Swiss distributors, which are, however, generally qualified as financial service providers subject to the FinSA;

\[ b \] the concepts of ‘offer’, ‘financial service’ and ‘advertisement’ to replace the former concept of ‘distribution’;

\[ c \] an alignment of the client categorisation rules based on EU MiFID concepts; and

\[ d \] a limitation of the requirement to appoint a Swiss representative and paying agent for offers of foreign collective investments to qualified investors.

In addition, non-Swiss financial service providers acting on a cross-border basis are subject to FinSA rules of conduct and organisational measures, as well as affiliation with an ombudsman office and, under certain circumstances, registration in a new client advisers register.

While the changes to the CISA and CISO in connection with the new FinSA and FinIA regime entered into force on 1 January 2020, a transitional period of two years applies for the majority of FinSA requirements. Until the implementation of the FinSA rules of conduct and organisational measures, financial service providers are required to maintain compliance with the relevant rules of the former regime. Further, registration in the client advisers register
and the affiliation with the ombudsman office is subject to a six-month transitional period, which will begin to run once the client advisers register is set up and the ombudsman office is recognised. This is expected to occur during the first half of 2020.

i  **Preferred vehicle for private equity funds**

Private equity firms investing in Switzerland are free to choose to set up both Swiss and non-Swiss structures (typically Jersey, Guernsey or Cayman structures) for fundraising and investment purposes. The preferred legal form depends on different drivers, such as (1) the tax transparency of the vehicle (i.e., whether it is subject to Swiss corporate taxes on income or capital gains), (2) restrictions and limitations on the investment activities of the private equity fund, (3) the limited liability of the management and the investors and (4) the close-ended nature of the fund.

Private equity funds investing in Switzerland may structure their investment by setting up either a Swiss structure contemplated by the CISA, namely a Swiss limited partnership for collective investments (the Swiss LP), a Swiss investment company (including the CISA-specific form called the SICAF) or any foreign law structure – whichever is the most appropriate for fundraising and investment. In practice, the predominant legal form chosen by sponsors is a non-Swiss structure – the Anglo-Saxon limited partnership (LP).

ii  **Swiss LP**

The Swiss LP is a CISS specifically designed for alternative investments, private equity and real estate development, construction or infrastructure projects. This legal form mirrors the LP or the Luxembourg SICAR.

The Swiss LP is a partnership whose sole purpose is collective investment. It benefits from a quasi-legal personality and is entitled to hold assets or claims. It conducts investments in risk capital and is subject to particularly flexible investment guidelines.

A Swiss LP is based on a partnership agreement, with at least one member being subject to unlimited liability for the commitments of the Swiss LP (the general partner). The general partner must be a Swiss company limited by shares and can only be appointed as a general partner of a single Swiss LP. While the Swiss LP is not subject to any capital requirements, the minimum share capital of the general partner must amount to 100,000 Swiss francs and be fully paid in. In the event that the Swiss LP has several general partners, those must together have a minimum paid-up share capital of 100,000 Swiss francs. The general partner may delegate investment decisions or other activities to third parties, provided that the delegation is in the best interest of the Swiss LP. In addition, the partnership agreement must be supplemented by a prospectus, which must be consistent with the statutory provisions.

The investors in the Swiss LP are the limited partners. They are liable only up to a specific amount. Although the limited partners may not be involved in the management of the Swiss LP, they benefit from information and certain governance rights (e.g., delivery of periodic financial information or information on the financial accounts). The Swiss LP is only open to qualified investors as defined in the CISA (see Section II.vii). Finally, the Swiss LP is a regulated entity that must have a prior licence from FINMA and is subject to FINMA’s ongoing supervision (see Section III.i).

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8  As a consequence of the limitation of the circle of investors, a Swiss LP cannot be listed on a securities exchange.
iii Investment company and SICAF

The SICAF is a Swiss company limited by shares whose corporate purpose is limited to the investment and management of its own assets, to the exclusion of any entrepreneurial activity. Along with its prospectus, the SICAF defines its private equity investments, investment policy and investment restrictions in its articles of association, as well as in its investment guidelines. The regulatory framework set out in the CISA with respect to the SICAF is quite limited. As a result, the SICAF is substantially governed by the provisions of the Swiss Code of Obligations that are applicable to ordinary companies limited by shares.

Swiss limited companies are not subject to the CISA and therefore not regulated by FINMA if their shares are listed on a Swiss stock exchange\(^9\) or their shareholders are exclusively qualified investors as defined under the CISA (see Section II.vii). To our knowledge, all investment companies have relied to date on this regulatory safe harbour. As a result, there are no SICAFs incorporated in Switzerland under the CISA. Most of the following developments will therefore be limited to the Swiss LP as the typical Swiss vehicle for private equity funds.

iv Other forms

Foreign private equity vehicles are frequently used by promoters active in the Swiss market. The choice of the specific foreign structure used will primarily depend upon the domicile and type of target investors, as well as on tax and regulatory aspects, in particular, depending on the jurisdiction of the investee entities or projects. For example, an EU structure may be used to get access to the EU market without having to obtain an authorisation in every country in accordance with the AIFMD regulation (i.e., passporting). The Swiss private equity community frequently uses foreign structures, mostly based in other countries in Europe, such as UK, Jersey or Scottish limited partnerships or Luxembourg SICARs. Those would, therefore, solely be subject to Swiss requirements regulating fundraising (i.e., fund distribution), as described below.

v Key legal terms

Generally, a Swiss LP may be set up for an unlimited period. That being said, in practice, a Swiss LP’s duration is usually contractually restricted to 10 to 12 years, with an extension option for another three years.

The partnership agreement governs the relationship between the limited partners and the general partner. Swiss law allows a significant freedom to the parties with respect to the regulation of their relationship, subject to a certain number of mandatory provisions. As a matter of principle, the partnership agreement includes provisions on the following items:

- **a** total capital commitment;
- **b** repayment of capital;
- **c** duration of the fund and possible extension;
- **d** management participation in the fund;
- **e** management fees;
- **f** investment policy, investment restrictions, risk diversifications, investment techniques;
- **g** reporting;
- **h** conditions for admission of new and withdrawal of existing investors;

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\(^9\) Where this is the case, listing rules of the Swiss exchange where the Swiss limited company is listed (SIX Swiss Exchange or BX Berne Exchange) must be complied with.
v i  Key items for disclosure

Both the Swiss LP and the general partner must be registered with the Commercial Register of the canton where they are incorporated. The Commercial Register is public and provides general information regarding the Swiss LP and the general partner, such as the capital, the registered office and the authorised signatories. The partnership agreement establishing the Swiss LP must also be filed with the Commercial Register after its approval by FINMA and is, therefore, generally available to the public. However, the financial statements of the Swiss LP, although available to its investors, are not available to the public. The aggregate amount of the capital commitments of the limited partners must also be registered with the Commercial Register. However, neither the names of the limited partners nor the individual commitments are available to the public. Although the liability of the limited partners of the Swiss LP is capped at a specified amount registered in the Commercial Register, additional financial commitments may be required by the partnership agreement.

Pursuant to the SFAMA guidelines on the charging and use of fees and costs (the Transparency Guidelines), which, in accordance with FINMA Circular 2008/10, are recognised as the minimum standard, certain information duties are imposed on distributors and Swiss representatives (see Section II.vii) of both Swiss and foreign funds. In a nutshell, investors are to be informed on fees, costs, rebates and retrocessions paid or received in relation to the fund. This information shall be disclosed in the fund documentation. Furthermore, with respect to retrocessions, their recipients must spontaneously inform the investor of the amount of the compensation received by giving the calculation parameters or the spread of those inducements. Upon an investor’s request, the recipients are to further disclose the amount actually received. Finally, the existence and nature of any conflict of interest that may arise from the payment of the retrocessions is to be disclosed to investors in this context.

v ii  Marketing rules and investor classification

Concept of offer, advertisement and financial service

Under the new regulatory framework, the former concept of ‘distribution’ of a CIS has been abolished and replaced by the concepts of ‘offer’ and ‘advertisement’ of financial instruments, as well as with the concept of ‘provision of financial services’. Generally speaking, an offer or advertisement of a financial instrument may trigger the ‘product level’ requirements (1) to establish a prospectus and a key information document (KID) under the FinSA, as well as (2) to appoint a Swiss representative and paying agent for foreign CISs under the CISA. The provision of financial services (i.e., certain services relating to financial instruments)
triggers various consequences under the FinSA and is described below. ‘Financial instruments’ not only include units or shares in the CIS, but also equity and debt securities, structured products, derivatives, structured deposits and bonds.

An ‘offer’ is defined as any invitation to acquire a financial instrument that contains sufficient information on the conditions of the offer and the terms of the financial instrument. The following four situations do not fall within the definition of an offer:

- the provision of information in reverse-solicitation cases, where no advertisement related to any specific financial instrument has been made by the financial service provider or an agent thereof;
- the nominal indication of financial instruments, accompanied, where applicable, by factual information (e.g., International Securities Identification Number code, net asset value (NAV), prices, information on risks, price trends, tax data);
- the mere provision of factual information; and
- the preparation, provision, publication and transmission to existing clients or financial intermediaries of information and documents prescribed by law or contract relating to financial instruments.

‘Advertisement’ is defined as any communication aimed at investors that draw their attention to certain financial services or instruments. Under the new regime, an advertisement for a CIS must be clearly identifiable as such. Further, it shall mention the prospectus and the KID on the CIS and where these documents can be obtained. The following, however, does not constitute an advertisement:

- the nominal mention of financial instruments whether or not related to the publication of prices, rates, NAV, price lists, price movements or tax data;
- announcements as regards issuers or transactions, in particular, if they are prescribed by law, by supervisory law or by rules specific to trading platforms;
- the provision or transmission by the financial service provider of an issuer’s communications to existing clients; and
- articles in specialised press.

The definition of a ‘financial service’ under the FinSA includes the purchase and sale of financial instruments. Pure distribution activity understood as any activity addressed directly at certain clients that is specifically aimed at the acquisition or disposal of a financial instrument is considered as a financial service. Only the provision of information on financial instruments to end investors qualifies as a financial service, however, which excludes interactions with supervised financial intermediaries. In a nutshell, the consequences of the application of the FinSA as a result of the provision of financial services are the following: (1) client segmentation between institutional, professional and retail clients, (2) the obligation to comply with rules of conduct, (3) the obligation to comply with organisational measures, (4) the affiliation with an ombudsman office, and (5) the registration of client advisers (i.e., individuals who actually provide financial services within a given institution or on their own) in a register (with an exemption for Swiss financial service providers subject to FINMA supervision, as well as for foreign financial service providers subject to prudential supervision in their home jurisdiction, provided that they only provide services to professional and institutional clients).
Concept of ‘qualified investors’

The requirements applicable to the offer and advertisement of a CIS in Switzerland depend on the regulatory status of the targeted investors. The revised CISA maintains the distinction between qualified investors and non-qualified investors, but the definition of qualified investors has been adjusted to align it with the client segmentation provided for by the FinSA. In particular, all institutional and professional clients under the FinSA are qualified investors under the CISA. The FinSA has introduced a flexible regime allowing the opting in and opting out across the different categories of clients. This election impacts the level of protection applicable to the relevant investors.

Qualified investors include the following:

a ‘institutional clients’ as defined by the FinSA, namely:
   • financial intermediaries as defined in the Banking Act of 8 November 1934, the FinIA and the CISA;
   • regulated insurance companies;
   • foreign clients subject to a prudential supervision in a similar way as financial intermediaries and insurance companies; and
   • central banks;

b other ‘professional clients’ as defined by the FinSA, namely:
   • public entities with professional treasury operations;
   • occupational pension schemes or other institutions whose purpose is to serve occupational pensions with professional treasury operations;
   • companies with professional treasury operations;
   • large companies (i.e., companies that exceed two of the following parameters: balance sheet total of 20 million Swiss francs; turnover of 40 million Swiss francs; or equity of 2 million Swiss francs); and
   • private investment structures with professional treasury operations created for high-net-worth retail clients;

c high-net-worth individuals (HNWIs) and private investment structures created for HNWIs (i.e., persons with a minimum net wealth of 2 million Swiss francs, or persons with the required professional training and experience combined with a minimum net wealth of 500,000 Swiss francs) having declared that they wish to be treated as professional clients (i.e., opted-out HNWIs and private investment structures established for HNWIs); and

d managed and advisory clients of financial service providers under certain conditions.

Investors who are not included in one of the above categories are non-qualified investors. The characterisation of an investor as being qualified has a bearing on the regulatory restrictions applicable to the offering and advertisement of interests in a CIS under the CISA (see below). Further, the segmentation of private, professional or institutional client has an impact on the requirements applicable under the FinSA (with respect to information duties, appropriateness and suitability checks, accountability and documentation obligations and transparency and diligence requirements).
Offer or advertisement of units in Swiss LPs

Private equity funds that are incorporated as a Swiss LP may only be offered or advertised to qualified investors. In practice, limited partners will generally be required to confirm their status as qualified investors by signing a declaration on the subscription form for an interest in the Swiss LP.

In accordance with the CISO, individuals controlling the general partner or partners may participate in the company as limited partners if (1) this is provided in the partnership agreement, (2) the participating interest stems from the private assets of the concerned individuals and (3) the investment is made at the time of the launch of the Swiss LP.

Offer or advertisement of foreign private equity funds to non-qualified investors

Foreign private equity funds may be offered or advertised to non-qualified investors (i.e., retail investors) in Switzerland if they are registered with FINMA. The main approval requirements are the following:

a) the CIS, the fund management company or the fund company, the asset manager and the custodian must be subject to public supervision with a focus on investor protection;

b) investor rights, investment policy, the company or fund management company and custodian must be subject to regulation equivalent to the provisions of the CISA;

c) the CIS must not be described in such a way as to deceive or confuse, namely with respect to its investment policy;

d) a representative and paying agent must be appointed for units distributed in Switzerland;

e) there must be a cooperation and information exchange agreement between FINMA and the foreign supervisory authorities responsible for distribution; and

f) foreign CISs may not be distributed in Switzerland unless and until the fund management company has appointed a representative to assume the representation obligations set out in the CISA.

In practice, foreign private equity funds are typically not eligible for registration for offering or advertisement to non-qualified investors in Switzerland, insofar as many of the requirements (typically, items (a) and (b) above), are not met.

Offer or advertisement of foreign private equity funds to qualified investors

Notwithstanding the above, foreign funds may still be offered or advertised to qualified investors. Under the revised CISA, the requirement to appoint a Swiss representative and a Swiss paying agent for foreign funds offered or advertised to qualified investors is substantially alleviated. In this context and subject to the transitional regime, no Swiss representative or paying agent is required in relation to offers or advertisements of foreign funds made to qualified investors other than for opted-out HNWIs and private investment structures established for HNWIs.

That being said, the new regime only applies as of 31 December 2021 or once the relevant financial service provider has implemented FinSA rules of conduct and organisational measures, whichever comes first. As a result, until then, any offer or advertisement of foreign funds to qualified investors will generally require compliance with the former rules; namely, the appointment of a Swiss representative and a Swiss paying agent, as well as the entry into of a written Swiss law-governed distribution agreement with the Swiss representative of the CIS, based on the requirements of the SFAMA guidelines on the distribution of CISs (the
Distribution Guidelines). Such requirements do not apply if only institutional investors are targeted or in instances where the offer would not have constituted distribution under the former regime.

**Other distribution and marketing rules**

The Distribution Guidelines, which are recognised by FINMA as minimum standards, provide, inter alia, for due diligence and information duties both for promoters and distributors of CISs. In particular, non-qualified investors are to be provided with objective information on investment character, opportunities and risks associated with a specific CIS on the basis of their experience and knowledge and the complexity of the CIS. In addition, the Transparency Guidelines provide for further disclosure duties with respect to fees, costs, retrocessions and rebates that apply in this context. Under these rules, foreign fund documentation, marketing materials and any other publications or websites, offered or advertised to unregulated qualified investors must disclose the identity of the Swiss representative and paying agent, the home jurisdiction of the CIS, the place where the relevant fund documents are available, as well as the place of performance and jurisdiction at the registered office of the Swiss representative.

In practice, a specific wording with respect to Swiss investors is added to those materials. In connection with the two-year transitional period, both the Distribution Guidelines and the Transparency Guidelines generally remain in force until 31 December 2021 (or until the implementation of the FinSA rules of conduct and organisational measures by the relevant financial service provider, if this comes earlier).

Further, marketing activities in Switzerland are also subject to the Swiss legislation against unfair competition that addresses commercial communication with customers and prohibits unfair business practices. Under the Swiss Unfair Competition Act, any behaviour or business practice that is deceptive or that infringes the principle of good faith in any other way with the result of affecting the relationship between suppliers and customers is deemed unfair and unlawful.

**viii Fiduciary duties to investors**

From a Swiss regulatory perspective, a Swiss LP is not required to have a sponsor. The general partner is bound by fiduciary duties towards the investors (limited partners) that depend upon the provisions of the partnership agreement. Generally, under the CISA, the general partner fiduciary duties include loyalty, due diligence and information duties. The SFAMA Code of Conduct, which has been recognised by FINMA as the minimum standard, gives specific guidance on these duties. In a nutshell, the general partner must manage the Swiss LP in accordance with the principle of equal treatment and must refrain from favouring certain investors at the expense of others. Furthermore, all CISA institutions must have internal regulations and appropriate organisation to ensure compliance with their fiduciary duties.

Although the model documentation for Swiss LPs (see Section II.ii) does not contain provisions limiting the liability of the general partner towards the limited partners, such a limitation may generally be inserted in the partnership agreement. However, contractual provisions limiting or excluding a party’s liability for wilful misconduct or gross negligence are null and void under Swiss law.
III REGULATORY DEVELOPMENTS

i Regulatory oversight

The formation of a private equity fund established in the form of a Swiss LP must be authorised by FINMA prior to perform any activity. Both the Swiss LP and the general partner must obtain a licence from FINMA (generally through a single regulatory process). The application is to be reviewed by an audit firm recognised by the Federal Audit Oversight Authority (FAOA). In addition, individuals controlling the general partner and any qualified participants (i.e., any person or entity directly or indirectly owning at least 10 per cent of the capital or voting rights in the general partner or who can have a material influence in another way) are subject to a fit-and-proper test by FINMA. The constituting documents (partnership agreement) also require FINMA’s approval. In terms of timing, subject to FINMA’s workload and in the absence of any unforeseen complications, the authorisation is generally issued within a three- to four-month period once all the required documents are filed. With respect to the fees, initial registration fee amounts to between 10,000 and 40,000 Swiss francs. FINMA further levies a yearly supervision fee, which is computed on the basis of the assets of the Swiss LP.

The Swiss LP, and its general partner, are then subject to the ongoing supervision of FINMA. The Swiss authority benefits from extensive audit and inspection rights over regulated entities. The Swiss regulatory regime is based on a ‘dual supervisory regime’, which requires regulated entities to appoint a FAOA-recognised auditor (which cannot be the audit firm that was in charge of reviewing the application), whose task is to verify whether the regulated entity complies with all applicable legal, statutory and regulatory requirements. The auditor’s report is addressed to both the entity and FINMA. Finally, the Swiss LP must appoint a depository and a paying agent, but the appointment of a custodian bank is not required.

Non-Swiss private equity vehicles may make investments in Switzerland without being subject to FINMA’s authorisation, provided that the vehicle is not deemed to be centrally administered in or from Switzerland (which would result in the fund being viewed as a Swiss fund). By contrast, a registration with FINMA is required before foreign CISs can be offered or advertised in or from Switzerland to non-qualified investors (see Section II.vii).

Furthermore, Swiss management companies or investment managers of a Swiss or non-Swiss CIS are, in principle, subject to a mandatory licence requirement in Switzerland under the FinIA. An exception applies to asset managers of a foreign CIS in which all investors are qualified investors and:

a the assets under management, including those resulting from the use of leverage, are below the threshold of 100 million Swiss francs;

b the assets under management are below 500 million Swiss francs (unleveraged) and the CIS is closed-ended (such as a Swiss LP) for a period of five years; or

c the assets under management belong to persons with whom the managers have business (e.g., group of companies) or family ties.

Asset managers managing below-threshold assets in a CIS are, however, required to obtain an authorisation from FINMA as ‘asset managers of individual portfolios’.
Non-Swiss managers of both Swiss and non-Swiss CISs with a branch or representative office in Switzerland are also required to register with FINMA. This presupposes that the foreign asset manager:

a. is subject to adequate supervision by its home regulator;

b. has sufficient financial resources and adequate organisation, as well as competent staff to operate a branch in Switzerland; and

c. is incorporated in a jurisdiction where its home regulator has concluded a specific cooperation agreement with FINMA.

Advisory activity conducted by a fund sponsor or promoter, for example, is, in most cases, construed as a financial service subject to FinSA requirements (see Section II.vii).

ii Taxation

The Swiss LP is treated as a transparent entity for tax purposes and is therefore not subject to Swiss corporate income tax on its income or gains, provided it does not directly hold real estate located in Switzerland. Income taxes are generally levied at the level of the investors. Swiss residents are subject to ordinary income tax on the ordinary income distributed by the Swiss LP. The value of their units in the Swiss LP is also subject to Swiss wealth tax.

Distributions made by Swiss LPs to both Swiss and foreign investors are generally subject to withholding tax at a 35 per cent rate, unless they correspond to distributions of capital gains or income realised from real estate held directly by the Swiss LP. Swiss investors will receive full refund, provided that they declare the income in their tax return or account for it in their financial statements. Foreign investors may qualify for an exemption from Swiss withholding tax, irrespective of the applicability of a treaty, under the affidavit procedure provided that at least 80 per cent of the underlying income is derived from non-Swiss sources and the investors demonstrate that they are not Swiss residents. In addition, foreign resident investors may also be entitled to a full or partial refund based on a double-tax treaty existing between their country of residence and Switzerland. Such refunds are typically granted by way of reimbursement rather than by way of exemption.

SICAFs and other investment companies incorporated as Swiss corporations and not regulated under the CISA (see Section II.i) are treated as non-transparent for tax purposes and therefore subject to corporate income tax and tax on net equity. The distributions are, in addition, subject to withholding tax. The issuance of shares of a SICAF or any other investment company in the form of a Swiss corporation is further subject to the Swiss issuance stamp duty. The tax treatment of the SICAF and investment company, as common limited companies, partly explains the absence of use of this type of vehicle in practice, other than as a mere intermediate investment subsidiary, as part of a larger investment structure of a foreign private equity fund (typically a foreign LP).

IV OUTLOOK

On 1 January 2019, a new type of licence, the ‘fintech licence’, was introduced into the Swiss regulatory framework for companies accepting public deposits but not using those deposits to finance a traditional banking activity (i.e., lending to business). Where this is the case, the aggregate amount of public deposits is limited to 100 million Swiss francs and may neither be invested nor interest-bearing. This new fintech licence involves less stringent regulatory requirements than a full banking licence, and leaner minimal capital requirements apply. In
this context, the minimum nominal capital of companies holding such a licence has to amount to at least 3 per cent of the public deposits and be, in any case, above 300,000 Swiss francs, and in each case to be fully paid in cash.

Traditional fundraising techniques and processes have been challenged in the past couple of years by the emergence of a new form of capital raising by start-ups in the form of initial coin offerings (ICOs), token-generating events and token sales. The new cryptocurrency and blockchain business models are challenging legal and regulatory models, and enforcement action by regulators all around the world is increasing. In this context, FINMA issued guidelines addressing the regulatory treatment of ICO structures. Generally, FINMA focuses on the economic function and purpose of the tokens, and on whether they are tradeable or transferable, to classify the tokens as payment tokens (cryptocurrencies), utility tokens or asset tokens. The classification of the tokens has an impact on the applicable legal and regulatory framework, such as the application of the anti-money laundering regime, the CISA and the Banking Act. Further, the classification of tokens as securities triggers the requirement for the issuer to establish a prospectus and, depending on the circumstances, may trigger the requirement to obtain a FINMA licence as a securities dealer. On 11 September 2019, FINMA published a supplement to its ICO guidelines outlining the treatment of ‘stable coins’. As a matter of fact, the requirements under supervisory law differ depending on which assets (e.g., currencies, commodities, real estate or securities) the stable coin is backed by and the legal rights of its holders. In addition, in December 2018, the Swiss Federal Council published a report on the legal framework for blockchain and distributed ledger technology in the financial sector. On this basis, a legislative process is currently under way in view of improving the Swiss legal framework conditions for distributed ledger technology by implementing a few selective amendments to existing legislations. The draft legislation, which will be discussed at the Swiss Parliament level in the first half of 2020, namely aims at improving legal certainty as regards the segregation of crypto-based assets from the bankruptcy estate and the tokenisation of assets such as shares, bonds and other financial instruments. The use of distributed ledger technology in financial markets through the tokenisation of financial instrument is increasingly popular, in particular for fundraising activities for start-ups and small and medium-sized enterprises in Switzerland.

Switzerland also aims to improve competitiveness in the area of collective investments. A legislative process is currently under way to introduce a new category of funds that are neither subject to approval by FINMA nor regulated under the CISA. A consultation process lasted until 17 October 2019. The proposal will be discussed by the Swiss Parliament in the course of 2020. This new category of funds, limited qualified investment funds (L-QIFs), would be exclusively reserved for qualified investors. The L-QIF would not be a new legal form (i.e., any existing forms of CIS, such as Swiss LPs, may be used as the basis of an L-QIF). As a result, existing Swiss CISs currently supervised by FINMA that would qualify as an L-QIF should be able to request the withdrawal of FINMA supervision. It is intended that the absence of FINMA authorisation and supervision for L-QIFs would be mitigated by the fact that L-QIFs would need to be managed by a fund management company itself supervised by FINMA. No limitation is expected to be imposed on the permitted investments by L-QIFs, which would be able to invest in any financial instruments as well as in cryptocurrencies or other specific products.

Overall, the Swiss regulatory framework is expected to continue to evolve over the coming years, with various changes designed to promote innovation and access to funding, while increasing client protection.
I GENERAL OVERVIEW

Private equity funds closed in 2019 raised US$537.2 billion. This represents the highest amount raised since the financial crisis and an approximate 16 per cent increase on the aggregate figure raised in 2018 (US$462 billion).\(^2\) Dealmaking dipped slightly, but was still strong: 2019 saw US$393 billion in buyout deals and US$224 billion in venture capital deals, compared with US$493 billion and US$271 billion, respectively, in 2018.\(^4\) The total number of funds closed increased marginally, but remained lower than the total number in 2017, while the trend towards larger average fund sizes continued. In 2019, the average private equity fund size globally was a record US$662 million.\(^5\)

As has been the case for several years, these overall fundraising figures are, to a quite significant degree, driven by the continued success, and ever-increasing sizes, of buyout funds, which accounted for more than 62 per cent of the aggregate capital raised,\(^6\) and in particular, the mega buyout funds (defined by Preqin as raising at least US$4.5 billion), which continue to return to market earlier and with ever-increasing fund sizes. In total, 2019 saw more than a quarter of private equity capital – US$138 billion – raised by the 10 largest funds. These included Blackstone Capital Partners VIII, which, subject to final allocations, raised over US$26 billion, representing the largest private equity fund ever raised; the US$17.5 billion Advent International GPE IX; the US$16 billion Vista Equity Partners VII; and the €11 billion Permira VII. Growth equity, venture and secondaries funds comprised 14 per cent, 9 per cent and 6 per cent of total fundraising, respectively.\(^7\)

The European private equity fundraising landscape has largely mirrored these trends, although there was a drop in aggregate fundraising to US$62.6 billion.\(^8\) This was largely down to 2019 being a slower year for mega funds capital raising in Europe. 2020 is expected to exceed the very successful 2018 and 2017 for European mega funds, with Ardian, EQT, Apax, BC Partners, Coller Capital, AlpInvest and Nordic (among others) all having announced mega fundraisings for 2020.

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1 Jeremy Leggate, Prem Mohan and Ian Ferreira are partners at Kirkland & Ellis International LLP.
3 ibid.
4 Preqin.
5 Private Equity International’s Annual Fundraising Report 2019.
7 Preqin.
8 Private Equity International’s Annual Fundraising Report 2019.

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As was the case in 2017 and 2018, when record levels of distributions by private equity managers helped underpin investors’ desire and ability to reinvest in private equity funds, the same is true of 2019, with exit activity and the strong flow of distributions continuing, leading to investors having significant levels of capital to deploy. The larger, top-performing managers have continued to benefit from this increased investor liquidity, in particular from the larger private equity investors, sovereign wealth funds, public pension funds and larger family offices, who, in tandem with their increased desire to gain greater control over capital deployment and more favourable economics from top-performing managers, have continued to write conspicuously larger cheques, concentrating their exposure in large-cap brand-name sponsors.

From an investor’s perspective, there is little indication that the flow of capital into private equity funds will slow down in 2020, not least as a result of the speed and scale by which private equity managers are returning to market with new funds. In 2019, funds hit an average 107 per cent of their target capital at the first closing. As further evidence of the market disparity between the haves and have-nots, which we have consistently reported on since 2015, a survey by Cobalt found the percentage of investors planning to pursue relationships with new managers in 2020 increased slightly from 2018, but was still lower than in 2017, and the same theme was also evident in a Private Equity International survey in November 2019 that found limited partners’ (LPs) top two selection criteria for manager relationships were track record (93 per cent of respondents) and team size and investment capacity (88 per cent). Dry powder continues to scale across all asset classes, with private equity managers holding approximately US$1.5 trillion in dry powder globally.

As the evidence above suggests, and in much the same vein as for 2018, investors are, on the whole, committing larger amounts of capital to fewer managers and generally seeking to consolidate their general partner (GP) relationships. This market polarisation continues to represent a significant issue for first-time or less experienced managers and for those that lack a truly differentiated strategy. The bifurcated market continues to restrict certain funds from reaching a successful closing, while the larger funds take an ever-increasing portion of investors’ total private equity allocation.

Europe and, more specifically, the United Kingdom, western Europe and the Nordic regions, have nevertheless seen a host of highly successful fundraisings in 2019. Permira, Cinven and Altor all held closings for their latest funds in 2019, with larger fund sizes than previously.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Jurisdiction and legal form

The key drivers in any fund structure are generally those of limited liability, tax transparency and efficiency, ease of use, and flexibility. Notwithstanding the wide range of possible structures that could be utilised, a limited partnership structure is the vehicle of choice for most UK fundraisings. As expanded upon further below, the general trend is for the fundraising market to adopt two main strategies in structuring: being located within the

10 Preqin.
12 Structures aimed at the retail market, such as venture capital trusts, are not considered here.
UK (thus being subject to the full range of UK tax and regulation, including – in whole or part – the Alternative Investment Fund Managers Directive (AIFMD)), or being located offshore (thereby being outside the UK (and EU) VAT and regulatory net).

The former strategy would generally utilise an onshore limited partnership, usually an English limited partnership (although Scottish or other jurisdictions may be used). The latter strategy would generally involve the use of an offshore-domiciled limited partnership – generally Guernsey or Jersey – although the former seems to be the favoured jurisdiction for offshore private equity funds, albeit with increasing competition from Jersey. Other possibilities include Delaware, the Cayman Islands and Bermuda, but these are very much the exception in a UK fundraising, primarily because of time zone, strength of local service providers and investor familiarity.

Some investors have preferences as to the location of the fund (usually because of the applicable regulatory or tax regime), and this may have an impact on the jurisdiction of the fund or its structure, or both; feeder vehicles or tax ‘blockers’ may have to be incorporated into the structure to cater for the specific needs of a single investor or a group of investors.

Other fundraisings can take the form of a wide range of onshore and offshore vehicles, such as the Luxembourg limited partnership (SCSp), SICARs, SIFs, RAIFs and French FCPIs or offshore companies, although these structures are not the focus of this chapter.

While each GP will claim to have a set of unique terms relating to its fundraising, there are a number of themes that are common to all, albeit with different formulations and treatments between various funds. While not comprehensive, the main negotiated terms of a private equity fund are as follows.

**Target size/cap**

The target size of the offering is of relevance to investors as they may wish to impose limits on the size of the fund to ensure that it is not too large for the team to manage, thereby ensuring that they focus on transactions of an appropriate size and in appropriate volume for their investment strategy. Thus, investors may seek to cap the size of a fund and, conversely, seek to subject their commitments to a size precondition (i.e., they would only be bound to invest if the fund reaches a ‘viable’ size), thereby ensuring that they would not be over allocated to that fund, or that the fund would have to make smaller investments in size or number.

**GP commitment**

The size of the personal commitment made by the executives and its form (i.e., whether financed personally, by waiver – less common in the UK and European market and increasingly less common globally as investors seek to ensure that sponsors and their executives commitments are in ‘cash’ – or by some other method) is also very pertinent to prospective investors who want to ensure they have ‘skin in the game’. Because of investor pressure, the expected number has been steadily increasing and is now likely to start at 2 per cent of fund commitments, although there is wide variation.13

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13 Institutional Limited Partners Association Principles Version 2.0, ‘General Partner Commitment’ states that ‘the GP should have a substantial equity interest in the fund and that it should be contributed in cash as opposed to being contributed through various management fees’. © 2020 Law Business Research Ltd
**Closing period**

This is the period during which more investors can be admitted to the fund. The ‘market’ position tends to be 12 months from the first closing of the fund; however, managers have argued for an increase as a response to the increase in time required to fundraise and deal with investor due diligence, etc. Investors have generally accepted this extended period, notwithstanding their concerns that the management team would be distracted from deal sourcing and investment activity by their fundraising efforts. While the very best GPs will raise new funds with relative ease when compared to other market participants, on the whole, GPs are being made to work harder than ever before to win commitments, with more firms and funds than ever before working across a broad spectrum of strategies.  


**Investment period**

This period during the fund’s life is reserved for investing. The manager will have full discretion to draw down all the funds available during this period (subject to relevant limitations such as investment policy and borrowing restrictions). Here, the old status quo of a five-year investment period is also being modified. Managers, in an attempt to avoid failing to invest their funds fully in the allotted period have argued for the ability to extend their investment periods. This has been met with a variety of responses from investors, some of whom were sympathetic provided that the approval mechanisms were satisfactory, and others who were unmoved and wanted to ensure that their commitments were time-limited to five years.

**Management fee**

It is usual for the management fee to be calculated as a flat percentage of committed capital during the investment period, stepping down to a (in many cases reduced) percentage of drawn-down or invested capital after the end of the investment period or on the raising of a successor fund. Investors are very sensitive regarding the scale of management fees and their impact on returns, and thus there has been some downward pressure and heightened scrutiny by investors, albeit with relatively limited success to date.

**Investment strategy and limitations**

The offering will specify the appropriate investment strategy to be followed by the fund and relevant limitations providing, for example, limits in relation to maximum exposure to any one investment sector, jurisdiction or industry limitations, as applicable. The investment strategy and limitations are an essential part of any fundraising, and investors are focused on ensuring that they understand any risks and to ensure that there is no ‘strategy drift’. The growth in importance of certain sovereign wealth funds, state-aided funds or political agencies has resulted in a number of pools of capital (e.g., EU regional aid) that are solely focused on a single jurisdiction or that are prohibited from investing in certain regions, and thus a number of exclusions to the investment policy may be negotiated, or ‘sidecar’ vehicles with a restricted investment mandate for investing alongside the main fund created, to cater for these specific investors.
**Investment-related fees**

In most cases, all transaction fees, break-up fees, directors’ fees or monitoring fees would be set off against the management fee so that the investors would receive some or all the benefit thereof, and investors have been pushing strongly, and often successfully, for a full set-off in their favour. These types of fees, and critically the full and accurate disclosure of such fees to investors, are also under increasing regulatory scrutiny, notably by the US Securities and Exchange Commission (SEC), which is affecting some major sponsors’ readiness to charge such fees, and hence affecting the market position more generally.

**Preferred return**

There is a general lack of movement with the preferred return, notwithstanding the current low-interest-rate economic environment, and it remains relatively constant in buyout funds, at 8 per cent per annum. Although some funds, most notably some of the largest private managers, have created more bespoke arrangements, they are still very much in the minority, and generally investors prefer less creativity in the structuring of the preferred return mechanism.

**Carried interest or distribution mechanism**

The standard carried interest payable to the manager, its executives, or both, in private equity funds is 20 per cent of the fund profits. There are two main methodologies for calculating the carried interest – the ‘fund-as-a-whole’ mechanism and the ‘deal-by-deal’ mechanism. The former method is most common in Europe, while the latter is most common (although its popularity is dwindling) in the United States. The fund-as-a-whole model is the main European model and is deemed to be investor-friendly in comparison with the deal-by-deal method; and although some high-demand European sponsors are moving towards the US model, most investor negotiations are based around mitigating the risk of any overpayment of carried interest (see below). Premium carry (where a manager is rewarded with an increased carry percentage above certain performance thresholds) or a movement (in whole or in part) to a deal-by-deal as opposed to a fund-as-a-whole waterfall is a signature of some of the best performing funds; however, neither mechanism is commonplace across the industry as yet.

**Escrow or carried interest clawback**

These provisions can be rather bespoke, as a number of facts and circumstances are relevant – for example, the distribution mechanism of the fund (see above), the creditworthiness of the carry recipients and the likelihood, in light of the investment strategy, of losses post receipt of carry. The fund-as-a-whole distribution model provides that the carried interest is payable only after investors receive an amount equal to the aggregate drawn capital and the preferred return thereon, thereby reducing the risk of any carry overpayment. As such, in Europe, despite the efforts of certain larger LPs, European managers are increasingly relying on clawback mechanisms rather than escrow accounts, which are more commonplace for funds with deal-by-deal waterfalls, as carry can be paid ahead of investors’ total aggregate drawn capital being returned to investors. Whether one or the other is used is often in response to the nature of the investors’ likely return or drawdown profile and the executives’ attitude to risk (i.e., whether they prefer an escrow or subjecting themselves to a later clawback risk).

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15 ILPA 2.0, ‘General Partner Fee Income offsets’.
Reinvestment
The ability for a fund to redraw prior distributions is of great importance to the manager to ensure that the fund manager has access to the full amount of investor commitments for the purpose of making investments, including amounts that may have originally been drawn down for management fees or other expenses, bridging investments, etc. The limited partnership agreement will typically set out the type of distributions that can be redrawn and for how long. Certain investors, such as funds of funds, may be unable to redraw from their own investors and thus push back strongly in this regard.

Exclusivity
This regulates what other funds the manager can raise, and when. This provision comes under discussion as management houses contemplate setting up bespoke side funds or managed accounts, or when the manager attempts to diversify into a multi-product asset management platform.

Default provisions
These set out the suite of remedies in relation to investors who default on drawdowns. In light of experiences since the most recent global financial crisis, and threatened and actual defaults, these provisions have become more extensive in scope. The increased protection for sponsors, and subsequent investor scrutiny of the knock-on effects to the fund in the event of an investor default, include provisions around management fee coverage and assignment of defaulting investors’ interests in the fund.

Key-man or suspension-of-investment-period provisions
These provisions have received a lot of investor attention over the past few years. They protect the investors from a ‘key-man event’ (i.e., if one or more of the key management personnel ceases to be involved in the management of the relevant fund). As expected, the trigger event is heavily negotiated and specific to each fund and sponsor, and thus much time and attention is given to this particular provision in fund documentation. This term is often linked with the exclusivity provisions, as the ability for a team to perform different functions for different funds is often curtailed.

Removal of the GP on a fault or no-fault basis
These provisions, alongside the key-man provisions, are governance provisions, which have been developing in fund documentation. The relevant voting thresholds and the implications for management fees and carried interest in the event of the removal of the GP are often fiercely negotiated as investors seek to ensure that they are sufficiently protected from a manager that has lost its way.

Most-favoured nation
The most-favoured nation provision entitles other investors to benefit from rights given by side letter or otherwise to other investors. Managers seek to limit applicability by size of commitment, legal status, timing of admission, etc., to both prevent against an ever-increasing administrative burden, but also to ring-fence the terms offered to larger, cornerstone or ‘first-mover’ investors.
Other negotiable terms

The high level of competition for investors’ capital and the enhanced due diligence referred to above has resulted in increased investor attention and negotiation on a number of key terms (most mentioned above). The main themes behind investors’ negotiations have been increased alignment of interest, governance and transparency – indeed, these are the three guiding principles enunciated in the Institutional Limited Partners Association (ILPA) Private Equity Principles Version 2.0 published in January 201116 – and while they, in their own words, ‘should not be applied as a checklist, as each partnership should be considered separately and holistically’, they are revealing as to the concerns of the investor community and serve as a useful basis for discussions on terms. ILPA is increasingly influential as its members also press sponsors to report in accordance with its standard format. Another theme in this market that is having an impact on terms is that of incentives for first closers or large investors. This is often given in the form of a reduced management fee or other economic incentive, although other incentives can be utilised, such as preferred access to co-investments alongside the fund or other enhanced rights. This is increasingly becoming a permanent feature for fundraisings in this market, and a number of funds currently in the market are reported to be offering such incentives.17

ii Key items for disclosure

The legislative backdrop set out in the UK Financial Services Act 2012 (FSA) makes it a criminal offence for any person knowingly or recklessly to make a statement, promise or forecast that he or she knows to be misleading, false or deceptive; or dishonestly to conceal any material facts, if he or she does so for the purpose of inducing, or is reckless as to whether it may induce, another person to engage in investment activity.18

Furthermore, a misrepresentation can occur under English law when an untrue statement of fact or law is made that induces the other party to enter into a contract and suffer a loss. An action for misrepresentation can be brought in respect of a misrepresentation of fact or law. There are three types of misrepresentation: fraudulent misrepresentation, negligent misrepresentation and innocent misrepresentation. If a party is found to have made a misrepresentation that induced another party into entering a contract, there are various remedies that may be awarded by the courts depending on which type of misrepresentation has been found to have occurred. Generally, the remedies for misrepresentation are rescission or damages according to the form of misrepresentation.

In addition, it is usual for a UK-domiciled manager to be authorised by the UK financial services regulator, the Financial Conduct Authority (FCA). It would also have to comply with the FCA’s rules, including the wide-ranging Principles for Business, which include obligations to pay due regard to the information needs of clients and to communicate information to them in a clear, fair and non-misleading manner, and with legislation and rules implementing the AIFMD that prescribe certain information disclosure requirements.

US securities laws and other legislation relating to disclosure and fiduciary duties, while outside the ambit of this chapter, would also be pertinent, as most UK offerings would be

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16 See https://ilpa.org.
18 Section 89 of the FSA.
extended to US investors, and thus misstatements, omissions or other misleading content may lead to SEC enforcement, federal or state action or civil action. European jurisdictions typically also impose similar ‘anti-fraud’ requirements.

As such, it is important that the manager performs a verification exercise to ensure that the investor has subscribed on the basis of the best available facts; the manager thereby minimises the risk of damages claims, recession claims or regulatory sanctions should the fund fail to perform as anticipated. As part of this, the manager will review the offering documents and other related promotions to ensure that all facts and circumstances that will be relevant to a potential investor have been adequately disclosed without material omissions, that all statements of fact are accurate, that statements of opinion are reasonable and are honestly held by those to whom they are attributed, and that all inferences that can be drawn from any of those statements are themselves accurate.

As a matter of best practice, this verification process should be performed by the sponsor before issuance of any promotional documents.

The main key items for disclosure to investors are usually set out in the final form offering memorandum, which would typically set out:

- the investment highlights, providing a detailed discussion of the investment strategy for the fund and the process by which investments will be made;
- the track record of the manager or of the relevant executives comprising the management team;
- the curriculum vitae and relevant experience of the key executives;
- a market overview, to provide investors with a macro view of the investment therein;
- the summary of key terms (see above);
- legal and tax matters, describing various regulatory and tax considerations in making an investment in the fund;
- risk factors, to make the investors aware of the risks inherent in an investment in the fund; and
- a summary of selected investments from the track record of the manager, thereby providing the investors with further data and other experience at a granular level.

iii Solicitation

The most common method of solicitation is by way of an offering memorandum, although this document evolves through a number of stages. It is first conceived as a ‘teaser’ pitchbook, which is distributed to potential investors to solicit their initial interest or as a follow up to preliminary meetings or due diligence. This is then developed into a draft offering memorandum, which is usually circulated to potential investors and is the main promotional document used for the ‘soft-circling’ or ‘hard-circling’ process before concluding discussions and circulating a final form offering memorandum to investors before the fund’s first closing. This process would also take into account the relevant AIFMD marketing strategy of the firm (see Section III).

In parallel to this process, it is common for the manager to establish a data site (usually electronic) containing further information on the manager, track record, executives, legal documentation and structure of the offering. Certain investors also tend to issue their own document and information requests in the form of a due diligence questionnaire (DDQ), which the manager must complete and return. Indeed, so common has the DDQ approach become that some managers now pre-complete a ‘standard’ DDQ for inclusion in the data
site so as to expedite the due diligence process. The same considerations as to the accuracy of information provided in the offering memorandum apply to the information provided in the data site or DDQ responses.

Any changes to the terms or other relevant parts of the offering (e.g., track record or revised valuations) that arise as the fundraising progresses are typically communicated to investors by way of an addendum to the offering memorandum.

The manager may also appoint a placement agent who would assist in the preparation of the suite of offering documents and in identifying and soliciting potential investors.

Throughout this process the manager and the placement agent, if applicable, must ensure that they comply with the AIFMD and the relevant marketing regulations of the pertinent jurisdiction of the investor (including the UK), make any required filings and disclosures, and obtain any required authorisation. While not the subject of this chapter, it should be noted that this body of law has been developing and is becoming more extensive (including with various lobbyist and ‘pay-to-play’ restrictions in the United States), and sophisticated placement agents or managers will now generally seek access (through their legal or marketing advisers) to regularly updated global surveys of the marketing or pre-filing and registration rules of each jurisdiction to ensure that the offering complies with local laws and regulations.

III REGULATORY DEVELOPMENTS

i Regulatory developments

Overview of the AIFMD

The AIFMD is the principal legislation constituting the regulatory framework applicable to the marketing and management of private equity funds in the UK and the European Union. The AIFMD broadly applies to managers under the following two circumstances: non-EU managers that intend to market a fund to investors in the EU; and EU onshore managers that intend to either market a fund to investors in the EU or manage a fund in the EU.

At present, non-EU managers may continue to rely on existing private placement regimes in individual EU Member States to market fund interests to institutional investors, subject to complying with certain minimum requirements under the AIFMD. These provisions are a subset of the compliance obligations applicable to fully authorised EU managers, and include:

\[ a \] prescriptive requirements detailing the information to be disclosed to investors prior to investment and on an ongoing basis;

\[ b \] a requirement to produce an annual fund report with certain prescribed content;

\[ c \] regulatory reporting requirements; and

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19 Some jurisdictions (notably Austria, France and Italy) have chosen either to terminate existing private placement regimes following the implementation of the AIFMD or to impose highly onerous compliance requirements that result in effectively precluding a non-EU manager from marketing a fund using private placement.

20 The private placement regimes in Member States were initially expected to be closed in late 2018 or early 2019. However (as explained later in this section), the timetable for these events will now depend on when (if at all) the EU lawmakers complete the necessary steps to extend the passport on a voluntary basis to non-EU managers.
For those EU jurisdictions that permit non-EU managers to actively raise capital under existing national private placement regimes, there is typically a requirement to register the fund in the respective jurisdiction ahead of any marketing. The level of detail involved in completing marketing registrations varies by jurisdiction, from straightforward notifications (after which a non-EU manager can commence marketing) to rigorous applications for marketing approval requiring extensive supporting documentation. Processing times are similarly varied, with some regulators permitting non-EU managers to market a fund immediately on the submission of a marketing notification, and others taking potentially three months to vet and approve applications for marketing approval.

The UK has chosen to adopt a relatively straightforward registration procedure under its national private placement regime. Non-EU managers may commence marketing a fund once a short marketing notification is completed and filed with the UK regulator, the FCA. In carrying on any marketing activities in the UK, firms are required to continue complying with the UK’s pre-AIFMD national marketing rules, the financial promotions regime. Therefore, firms continue to target only those investors (such as regulated firms and high-net-worth entities) that fall within one or more exemptions to the financial promotion restrictions under UK law.

The AIFMD gives EU Member States the discretion to impose stricter requirements on non-EU managers in addition to the minimum requirements set out above. These stricter ‘gold-plated’ requirements may flow from other provisions of the AIFMD (otherwise not applicable to non-EU managers). For instance, non-EU managers intending to market a fund in Denmark or Germany are required to appoint a depositary for that fund, an obligation that otherwise applies only to fully authorised onshore managers (see below). The UK has chosen not to apply any gold-plated requirements to non-EU managers.

As a consequence of these registration requirements, a non-EU manager must consider, for each fund that it proposes to raise in the EU, the point in time at which it will have to register the fund for marketing with a local regulator. This in turn will depend on how local regulators interpret the term ‘marketing’ under the AIFMD. In the UK, for instance, the FCA has taken the view that certain ‘soft marketing’ activities, such as the circulation of a promotional presentation on the fund or a draft private placement memorandum to UK investors, do not constitute marketing for AIFMD purposes. Consequently, firms may carry on such activities in the UK ahead of registering the fund with the FCA (on complying with the UK financial promotion regime). Regulators in EU Member States may adopt a different interpretation of marketing (and some do), potentially leaving a non-EU manager with a narrower range of permissible soft-marketing activities that can be undertaken in those jurisdictions before registration. To the extent permitted by a local regulator, soft marketing enables a non-EU manager to gauge whether there is sufficient investor interest in a particular jurisdiction to justify the initial registration and ongoing AIFMD compliance costs for marketing a fund in that jurisdiction.

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21 The AIFMD defines marketing as a direct or indirect offering or placement, at the initiative of the manager or on behalf of the manager, of units or shares of an alternative investment fund it manages, to or with investors domiciled or with a registered office in the European Economic Area.
The preamble text to the AIFMD clarifies that the requirements under the AIFMD are not intended to apply to situations where an EU investor invests in a fund of its own initiative. This ‘reverse solicitation’ carve-out is (depending on facts and circumstances) being relied on by non-EU managers who receive indications of interest and requests for additional information from investors in an EU jurisdiction who have not otherwise been solicited by the manager.

The concepts of ‘soft marketing’ and ‘reverse solicitation’ under the AIFMD will be revised as a part of the implementation of the forthcoming Omnibus Legislation, as further discussed below.

EU onshore managers whose assets under management exceed certain thresholds (see below) are subject to the AIFMD’s full requirements. These requirements include applying for and obtaining permission to manage alternative investment funds from local regulators, and thereafter complying with a wide range of ongoing requirements on matters such as regulatory capital, internal governance, systems and controls, remuneration and, significantly, the appointment of a depositary to perform cash monitoring, safe custody, asset verification and oversight functions in relation to managed funds. In addition, the minimum disclosure and transparency obligations discussed above that apply to non-EU managers also apply to onshore managers. Onshore managers receive an important trade-off for complying with these onerous obligations, in that they benefit from an EU-wide ‘passport’ under the AIFMD that they can use to market EU funds to EU investors or manage funds across the EU, or both, without registering with local regulators. Despite the passport’s intention of giving onshore managers the freedom to market or manage EU funds without complying with local requirements, some national regulators have placed additional requirements on onshore firms using a marketing passport, which currently include appointing a local agent or paying a passporting fee, or both.

Onshore managers that are authorised under the AIFMD are currently not entitled to use a passport to market a non-EU fund in the EU. Rather, onshore managers of such funds are placed on the same footing as non-EU managers in being required to register a non-EU fund for marketing in a particular jurisdiction under national private placement rules.

Onshore managers whose aggregate assets under management fall below the AIFMD’s authorisation threshold are not required to be authorised under the AIFMD and are only subject to a limited number of requirements under the AIFMD. They are not entitled to benefit from the marketing or management passport under the AIFMD.

Packaged retail and insurance-based investment products
The requirements under EU Regulation No. 1286/2014 on key information documents for packaged retail and insurance-based investment products (the PRIIPS Regulation) became applicable on 1 January 2018. The PRIIPS Regulation requires firms to produce a key information document (KID) if they ‘make available’ a packaged retail and insurance-based investment product (PRIIP) to retail investors in the EU. The KID is meant to set out the risks, costs and expected returns of the underlying product in a standardised format,
and is intended to help retail investors compare products. The rules have extraterritorial application, so they apply to both EU and non-EU managers that make PRIIPs available to retail investors in the EU.

The definition of a PRIIP is extremely wide and covers investment funds and related investment pooling vehicles. The rules do not contain specific carve-outs for carried interest and co-investment vehicles, which managers might choose to make available to retail investors such as ‘friends and family’-type investors and EU-based executives within their own organisations. Managers continue to review the application of the rules to these structures on a case-by-case basis.

These requirements will not be applicable to firms who market funds exclusively to large institutional investors in the EU, since such investors are likely to be treated as professional rather than retail investors. The rules state that retail investors may elect to be treated as professional investors in relation to a particular investment fund or type of investment fund, and they permit managers to treat such investors as elective professional investors (therefore not requiring managers to produce a KID in respect of such investors) subject to following a mandatory assessment and ‘opt-up’ procedure. In particular, this procedure requires managers to undertake adequate assessments of: (1) the expertise, experience and knowledge of the retail investor, to ensure that the investor is capable of making its own investment decisions and understanding the risks involved; and (2) the retail investor’s recent investment activity, financial instrument portfolio and professional background, to ensure that these meet certain minimum prescribed criteria. In addition, the manager is required to make written disclosures regarding the protections that the retail investor might lose as a result of being treated as an elective professional investor.

Finally, following the implementation of the revised Markets in Financial Instruments Directive (MiFID) in the EU on 3 January 2018, local authorities in the EU (including UK local government pension schemes and their administrators) are treated as retail investors by default, and managers seeking to market investment funds to such investors without producing a KID would have to follow a different opt-up procedure to treat them as elective professional clients. The opt-up procedures for local authority investors may differ by EU jurisdiction, and managers should check the requirements on a case-by-case basis.

**Extension of the AIFMD passport**

According to the AIFMD, the European Securities and Markets Authority (ESMA) may recommend that the benefit of the AIFMD marketing passport be extended to non-EU managers who choose to register with an appropriate EU regulator (their ‘Member State of reference’) and comply with the AIFMD in full. Pursuant to the AIFMD, the EU lawmakers take the necessary legislative steps to extend the passport on a voluntary basis to non-EU managers within three months of receiving a ‘positive’ opinion from ESMA. After this time, non-EU managers choosing not to become fully authorised and compliant with the AIFMD may continue to market funds to EU investors on complying with local national private placement registration requirements, as well as the minimum requirements under the AIFMD applicable to them.

Under the AIFMD, this voluntary regime was initially expected to come to an end in late 2018 or early 2019, when it was anticipated that all national private placement regimes in the EU would be terminated and all non-EU managers would be required to become fully authorised under and compliant with the AIFMD.
ESMA has taken certain preliminary steps in publishing advice and opinions on the extension of the AIFMD passport to firms and funds in various non-EU jurisdictions on two separate occasions. On 30 July 2015, it concluded that Jersey, Guernsey and Switzerland presented no significant obstacles to the extension of the AIFMD passport. On 19 July 2016, ESMA issued positive advice with respect to the extension of the passport to Canada, Guernsey, Hong Kong, Japan, Jersey, Singapore and Switzerland and caveated opinions with respect to Australia and the United States.

The Commission, Parliament and the Council have been considering ESMA’s advice and are yet to issue any formal communication on when they will take the necessary legislative steps to implement it. At the time of writing, the general view among industry participants is that these steps are not likely to be taken in the near future.

**Proposals to amend the AIFMD**

On 1 August 2019, the cross-border directive on distribution of collective investment undertakings and a related regulation came into force across the EU. Both pieces of legislation (together the Omnibus Legislation) will start to apply following a period of two years (i.e., from 2 August 2021), and will amend (among other matters) certain provisions under the AIFMD relating to the cross-border distribution of investment funds. The key changes under the Omnibus Legislation include:

*a* permitting authorised EU managers to undertake certain defined ‘pre-marketing’ activities, with a view to testing investors’ interest in an investment fund, prior to obtaining a marketing passport for that fund. An AIFMD marketing passport will not be required where no subscription documents (including in draft form) are distributed, and no final form constitutional or offering documents are distributed to investors;

*b* EU managers will be required to notify their home state regulator within two weeks of commencing pre-marketing in any EU Member State;

*c* a formal limitation on managers’ ability to rely on reverse solicitation, where a subscription within 18 months of the commencement of any pre-marketing activity will be deemed to have resulted from active marketing, triggering the passporting requirement under the AIFMD;

*d* allowing for the discontinuation of marketing and the removal of funds from EU regulators’ registers (subject to certain conditions being met, including conditions relating to investor participation levels); and

*e* requiring EU managers seeking to appoint a third party to carry out pre-marketing on their behalf to ensure that such third party is a MIFID investment firm (or a tied agent of a MIFID investment firm, a Capital Requirements Directive IV credit institution, an undertaking for collective investment in transferable securities management company or another EU alternative investment fund manager).

As drafted, the requirements under the Omnibus Legislation do not appear to apply to non-EU managers marketing under the national private placement regimes of EU Member States. However, the legislation expressly prohibits EU Member States from adopting laws and regulations that are more advantageous for non-EU managers, and as such, there is a concern that EU Member States may seek to impose similar requirements on non-EU managers.
AIFMD review

Article 69 of the AIFMD requires the European Commission to review the functioning of the AIFMD; in particular, its impact on investors within the EU and in third countries, and the degree to which its objectives have been met. In 2019, KPMG conducted a general survey addressed to the stakeholders that are most affected by the AIFMD and produced a report with its findings. The report is lengthy and provides an indication of the topics that are likely to be considered by the European Commission in its review. These include a lack of harmonisation in implementing the rules across EU Member States, non-effective reporting requirements, inconsistent leverage calculation methodologies, onerous requirements in respect of investments in non-listed companies and divergent approaches across Member States in implementing the AIFMD marketing passport. The European Commission will continue its review of the AIFMD, taking into consideration the report’s information and conclusions alongside other sources of data and further analysis. More information will be available in 2020 when the European Commission issues its reports to the European Council and the European Parliament.

Brexit

On 23 June 2016, the UK electorate voted for the United Kingdom to leave the European Union and, consequently, on 29 March 2017, the UK government invoked Article 50 of the Treaty of the European Union, commencing the two-year period for negotiating the terms of the UK’s withdrawal from the EU (Brexit). The European Union and UK government mutually agreed to extend the date of the UK’s withdrawal twice. After a number of iterations, the European Commission and the UK’s negotiators reached a provisional agreement on the terms of the United Kingdom’s withdrawal from the EU in October 2019. The UK formally left the EU on 31 January 2020 at 11pm, after which the UK entered the transition period specified in the withdrawal agreement, which is scheduled to end on 31 December 2020.

On the expiry of the transitional period, UK-based financial services firms will cease to benefit from passporting rights under EU legislation, including the marketing and management passporting rights currently available to UK managers authorised under the AIFMD. Should UK fund managers lose passporting rights under the AIFMD, they would be treated post-Brexit (in the absence of any bespoke arrangements) as a third country and be subject to the same fundraising regime currently applicable to non-EU managers. In these circumstances, to fundraise in the EU, UK managers would have to comply with the initial registration and ongoing AIFMD obligations required under the national private placement regimes of individual EU Member States (as set out above).

In the UK, the FCA has made provision for a ‘temporary permissions regime’ so that EU firms and investment funds have a backstop to enable them to continue their business in the UK with minimal disruption on the UK’s departure from the EU and the expiry of the transitional period. The regime will permit EU-based managers who have been relying on a passport to market funds in the UK to continue temporarily marketing in the UK for a period of three years, subject to having complied with certain notification requirements. The notification window for this temporary permissions regime was extended following the delay to the UK’s withdrawal process and closed at the end of 30 January 2020.

For non-EU managers, it is unlikely that Brexit will prompt fundamental changes to the manner in which funds are currently marketed in the UK or elsewhere in the EU, and such managers are expected to continue to comply with the registration requirements under the UK’s national private placement regime. However, once the EU lawmakers take the
necessary steps to extend the AIFMD passport to non-EU managers, the UK will no longer be available as a Member State of reference for non-EU managers who opt to take advantage of the passport’s extension.

**ii Tax developments**

One of the main fund structuring objectives is to ensure that the investors in the fund suffer no additional taxes as a result of investing through the fund rather than investing directly in the underlying assets. For this reason, private equity funds in the UK are typically established as limited partnerships so that they are viewed as transparent for most UK tax purposes and do not fall into tax and generate tax leakage at the fund entity level.

On the basis that the fund is treated as tax transparent, the characterisation of the receipts of the fund as income (e.g., interest or dividends) or capital (e.g., sale proceeds) should be preserved for UK-resident investors (and some other categories of investors – although this is jurisdiction-specific and on a case-by-case basis). While this means that withholding tax issues can arise without appropriate planning, it historically enabled investors to secure capital treatment for any carried interest. With a current difference in rates of up to 45 per cent (for income) against up to 28 per cent (for capital), securing such capital treatment is an important objective for most UK-resident carried interest holders. For those carried interest holders who are UK-resident but domiciled outside the UK, there is also the possibility to defer or keep the proceeds outside the purview of the UK tax regime with appropriate structuring (known as the ‘remittance basis’ of taxation), although this planning has been somewhat eroded in recent years (see further below).

However, there are several different regimes in the UK that can treat at least part of a carried interest return as income rather than capital. These relate to: (1) disguised investment management fees (DIMF); (2) income-based carried interest (IBCI); and (3) employment-related securities (ERS).

The DIMF rules took effect from 6 April 2015 and, very broadly, are designed to ensure that individuals involved in the management of certain investment schemes are taxed on the receipt of management fees from investment funds as either trading income or employment income (in both cases, at rates currently of up to 47 per cent). The rules seek to address structures that would otherwise result in a portion of any management fees being taxed as investment returns in the hands of the individuals (often at capital gains tax rates or lower).

The IBCI rules took effect from 6 April 2016 and, if applicable, tax carried interest as DIMF trading income (as above) if it constitutes IBCI (as opposed to capital gains). In summary, the extent to which carried interest is IBCI depends on the average holding period of the underlying investments of the scheme that gives rise to the carried interest. There is currently an exclusion from the IBCI rules for carried interest that constitutes an employment-related security (see below).

The ERS rules (which, unlike the more recent DIMF and IBCI regimes, have existed since 2003) may bring profits on certain ‘securities’ into charge as employment-related earnings (and taxed at current rates of up to 47 per cent). Securities for these purposes include units in a collective investment scheme, which, under the ERS rules, include partnership interests in a carried interest partnership. Employment includes any former employment as an ‘office-holder’ (which extends to directors). In addition, ‘salaried members’ are also treated as employees for these purposes. However, the ERS rules may not be relevant to partners...
in a partnership (other than salaried members in a UK limited liability partnership – as above – or partners who are also directors of companies within the fund structure or fund portfolio companies).

In addition to the DIMF and IBCI rules described above, further changes were made in 2015 to the way UK capital gains tax rules are applied to carried interest. From 8 July 2015, ‘base cost shift’ was abolished and a new minimum level of taxation imposed on carried interest. These changes were designed to ensure carried interest holders are taxed on their true economic gain – whereas historically base cost shift would have given certain carried interest holders deductions in excess of the sums actually given by them as consideration for the acquisition of the right to that carried interest. The effect of the rules is that all carried interest arising on or after 8 July 2015 is subject to a minimum level of taxation of 28 per cent. The rules do not, however, displace pre-existing income tax rules, so when carried interest comprises income amounts (e.g., interest, dividends), income tax is due (at rates of up to 45 per cent) as well as capital gains tax. Relief may be claimed to prevent double taxation, but particular care has to be taken with regard to UK-resident carry holders who are also US taxpayers to ensure double taxation between the UK and the United States does not arise. Consequently, it remains critical to ensure that, on first principles, carried interest retains the character of underlying returns in the form of capital gains, and that underlying capital returns are not reclassified as income.

It should also be noted that the UK capital gains tax rate was reduced from 28 per cent to 20 per cent with effect from 6 April 2016, but this reduction does not apply to carried interest, which continues to be taxed at the 28 per cent rate.

From 6 April 2017, individuals who have been resident in the UK for 15 out of the past 20 years are deemed domiciled in the UK for all tax purposes, with the effect that the remittance basis of taxation referred to above is no longer available. Further, if an individual has a domicile of origin in the UK and subsequently leaves the UK, shedding that domicile (acquiring a domicile of choice somewhere else), the UK domicile of origin will resurrect itself on the individual returning to the UK and becoming UK-resident.

On the UK real estate side, new rules came into force in April 2019 bringing non-UK residents into the charge to UK capital gains tax on the disposal (both direct and indirect) of UK commercial real estate, which represents a significant change for funds (and their investors) investing in UK real estate.

More generally, the impact of the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) project, and of the EU anti-abuse directives, ATAD I and ATAD II, is starting to be seen across many jurisdictions, particularly in the response to the BEPS treaty-abuse and anti-hybrid measures, in response to which the UK implemented detailed and far-reaching anti-hybrid rules with effect from 1 January 2017. Likewise, the Danish cases on the interpretation of beneficial ownership and abuse of rights have made a significant impact, from a withholding tax perspective, on most international fund structures and the flow of funds from EU subsidiaries ultimately to fund investors.23

23 T Denmark and Y Denmark v. the Danish Ministry of Taxation (joined Cases C-116/16 and C-117/16) and N Luxembourg 1, X Denmark A/S, C Danmark I and Z Denmark ApS v. the Danish Ministry of Taxation (joined Cases C-115/16, C-118/16, C-119/16 and C-299/16)).
Looking forward, there continues to be a number of developments and challenges. Perhaps most notably the latest OECD ‘BEPS 2.0’\(^2^4\) initiative should not be underestimated, with the potential to change the global tax landscape significantly by altering how profits are allocated between jurisdictions (Pillar 1) and introducing a new globally coordinated regime for minimum tax and anti-base erosion measures (Pillar 2). The EU mandatory disclosure regime, which entered into effect on 25 June 2018, adds to compliance burdens and, while first reporting does not begin until August 2020, the disclosure obligations capture arrangements from 25 June 2018 (where conditions for disclosure are met). As a result, procedures for information gathering and reporting should be put in place by affected parties now. Brexit, BEPS 2.0 progress and EU Member States’ implementation of the ATADs, therefore, are key items to watch carefully as we progress through the year ahead.

IV OUTLOOK

Top-performing managers remain very well positioned for the foreseeable future. Investors have significant liquidity with more on the immediate horizon as legacy funds continue to make healthy distributions and the almost universally high asset prices seen in the market will, in the short term, further exaggerate this state of affairs. There continue to be a substantial number of challenged fundraisings, and those managers unable to sufficiently differentiate themselves by strategy, track record or unique selling point, or indeed those who display outperformance of the market, may have to adopt alternative strategies such as deal-by-deal financings, single investor mandates (including managed accounts) or bespoke or particularly investor-friendly economic terms, rather than simply benefit from rising asset prices. While a number of first-time fund sponsors have been successful, the bar for entry is set high.

The market for managers selling stakes in themselves to third parties has been on the rise for some time, and is now no longer a minority activity, but a part of the mainstream private equity industry. Investor sentiment remains mixed, however, with 45 per cent of investors believing that managers that sell stakes in themselves to third parties make them a less attractive investment partner, while 12 per cent see such activity as a positive.\(^2^5\) Investors remain vigilant on ensuring alignment of interests between manager and investors, focusing on issues surrounding the control and governance of the broader business (in particular, investment strategy) as well as the use and source of management fee revenue and sponsor commitment.

Secondaries, fund restructurings and recapitalisations are now further entrenched in the industry as an established, adaptable and opportunistic firm or portfolio management tool. The liquidity opportunities available and explored by investor and manager alike continue to offer enhanced flexibility to all involved. Managers are also increasingly seeking to delay exits of some of their top-performing assets, ‘the GP-led secondaries market, perhaps the largest beneficiary of extended holding times, has seen explosive growth over the past decade and is the fastest-growing sector in the secondaries space’.\(^2^6\)

\(^2^4\) Base Erosion and Profit Shifting Project – ‘Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy’ (May 2019) and ‘Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy’ (January 2020).


The outlook for private equity fundraising in 2020 is, in the main, positive. This is driven by the large number of firms either planning to raise a fund or actively market one. The industry is increasingly driven by the larger managers’ timing, and target fund sizes. Several large European and many similar-sized North American managers can be expected to raise funds in 2020. Although investor appetite for smaller funds still exists – *Private Equity International* reports 50 per cent of investors will consider first-time managers opportunistically, but just 8 per cent have a defined pool of capital to allocate to such managers – and track record above all else remains the key motivator for investor commitments, concerns regarding a market correction and the ability of smaller managers to remain competitive in an environment of seemingly ever-increasing asset prices, mean that the bifurcation of the fundraising market between smaller and larger managers remains prominent.
I GENERAL OVERVIEW

Given the continuing excellent performance of the private equity fund industry, private equity fundraising has remained very strong even though it slowed down in 2019 as compared with prior years. In fact, fundraising has been so strong over the past few years that CNBC has reported that at the end of 2019, the private equity fund industry was sitting on US$1.45 trillion in dry powder. This is the highest on record and more than double what it was just five years ago. This amount of dry powder has increased competition for deals and has delayed the deployment of capital by private equity funds given high valuations this late in the cycle. As a result, some investors have expressed concerns about returns going forward and investors generally intend to commit less fresh capital to private equity funds over the next 12 months. As a result, it is more critical than ever for fund managers to differentiate themselves in this market to attract investments from investors.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Formation considerations

The selection of the jurisdiction for the establishment of a private equity fund will depend, in part, upon the types of investors the fund sponsor contemplates soliciting. For instance, if the investors are expected to be comprised exclusively of US investors, the fund manager will tend to select a US-domiciled fund to match the fund’s jurisdiction with that of its investors. If, instead, non-US investors are also expected to invest in the fund, the fund
sponsor may allow these investors to invest in its US-based fund or may, if the investors would prefer a non-US domiciled vehicle, offer a fund established in a non-US jurisdiction (e.g., the Cayman Islands) to these investors that would invest on a parallel basis with the US-domiciled fund. Further, if the investors are from Europe, the fund sponsor may opt to create a European-domiciled fund (e.g., a fund formed in Luxembourg or Ireland).

Private equity funds are generally formed as limited partnerships. For US-domiciled funds, it is very typical to form the fund in the state of Delaware and this is by far the leading jurisdiction for the formation of US-based investment funds. A couple of factors have contributed to Delaware’s dominance in this area. Delaware has very flexible statutes that respect freedom of contract and maximise the ability of the parties to a contract to reflect the terms of their agreement. In addition to this statutory advantage, Delaware provides specialised courts for business entities, which can bring a significant amount of expertise and thoughtfulness to any disputes that may arise under the fund’s governing document. It is also relatively inexpensive to form a fund in Delaware and there is a substantial industry of service providers in Delaware that will facilitate the formation and maintenance of a Delaware entity. While we do sometimes see US-domiciled private equity funds formed as Delaware limited liability companies, we view this as less common due, in part, to the less developed case law around limited liability companies given the statute is relatively new and more significantly due to the fact that some non-US jurisdictions may tax an LLC as a corporation, thus, making a limited liability company less ideal than a limited partnership for non-US investors that would otherwise be comfortable investing in a US flow-through entity.

In terms of non-US private equity funds, the Cayman Islands is one of the leading non-US jurisdictions for private equity funds. It enjoys its leading status due, in part, to an excellent roster of service providers in the jurisdiction and very flexible statutes that have been modelled after Delaware law to a large degree. Some investors, particularly those resident in certain countries in Europe, may not be able to invest in a fund based in a Caribbean tax haven such as the Cayman Islands. Instead, these investors may only be able to invest in a fund domiciled in a European jurisdiction such as Ireland or Luxembourg. However, the costs and ongoing regulatory burdens associated with managing a European-domiciled fund (particularly for fund managers that are not already subject to these obligations) can be quite extensive. As a result, fund managers that are seeking to receive capital commitments from these investors generally will need to consider whether there is sufficient interest from other similarly situated European investors to justify the additional cost incurred by the fund manager with respect to the operation of a parallel fund for these investors.

With regard to the tax treatment of a private equity fund, the general goal, unless other circumstances dictate a different result, is to give the investors flow-through tax treatment all the way down to the underlying portfolio investments. There could be tax reasons why that may not be ideal from an investors’ perspective. For instance, a non-US investor may be worried that such tax treatment with respect to a US investment may create a need to file a tax return in the US, a result many non-US investors seek to avoid. This is often the case in private equity funds operated by US-based private fund managers that conduct a direct lending fund strategy. In addition, a US tax-exempt investor may prefer to avoid ‘unrelated business taxable income’ generated from one or more of the fund’s portfolio investments. To eliminate these adverse tax consequences for such investors, the fund manager generally will create what are known as ‘alternative investment vehicles’ that are either subsidiary entities of the fund or parallel vehicles to which investors of the main fund contribute capital directly for a single investment.
ii Disclosure matters

As one might expect, the offering of an interest in a private equity fund constitutes the offering of a security under the US securities laws. To comply with all of the fund manager's obligations under the US securities laws, the fund manager must provide disclosure of all material facts to an investor in connection with the offering of interests in the fund. This is commonly stated as a duty to ensure that the offering documents do not contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading. Because the fund manager and its control persons can have personal liability for a violation of this duty, fund sponsors are very careful and thoughtful with respect to the disclosure set forth in an offering document. In this respect, some significant items that must be studied closely are whether the disclosure regarding the investment strategy and the discussion of the risk factors and conflicts of interest encompass all of the material considerations associated with the fund manager's business and the particular strategy to be conducted by the fund manager with respect to the fund.

Another area where fund counsel and the fund manager spend a considerable amount of time relates to the presentation of the prior performance track record of the fund manager contained in the pitch book or the offering document of the private equity fund to be managed by the fund manager. One must confront the following issues.

a How portable is the track record (e.g., if the fund manager is newly established and its track record is derived from the fund manager's investment team at a prior investment management firm)?
b Does the manager have sufficient supporting documentation to justify the use of the track record?
c Is the new private equity fund's strategy substantially similar to the strategy that generated the prior track record?
d Are all of the material assumptions associated with the track record set forth in the performance presentation?

It is important for fund counsel and the fund manager to comb through the disclosure in the pitch book and offering document to ensure appropriate items are footnoted and that there are no promissory or superlative statements.

iii Solicitation of investors in the United States

General prohibition

The general rule governing US securities offerings specifies that:

[un]less a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.8

8 Section 5 of the US Securities Act of 1933.
Exception for private placements by an issuer

Section 4(a)(2) of the US Securities Act of 1933 (the Securities Act) specifies that the provisions of Section 5 ‘shall not apply to [t]ransactions by an issuer not involving any public offering’. To provide the industry with further guidance regarding this exception, the US Securities and Exchange Commission (SEC) crafted Regulation D, which was a safe harbour intended to provide detailed guidance regarding Section 4(a)(2). Given that Regulation D is a safe harbour, an offering made in accordance with Regulation D is deemed to comply with Section 4(a)(2). Private equity funds typically rely on Rule 506 of Regulation D since it contains no dollar limitation on the amount of capital that may be raised, unlike other rules set forth in Regulation D. Rule 506 provides for two separate ways to conduct the offering. One is pursuant to Rule 506(c), which allows a fund manager to publicly offer interests in a private equity fund. Rule 506(c) is a very new rule (adopted in 2013) that the SEC was obligated to adopt in connection with the passage of the Jumpstart Our Business Startups Act, or JOBS Act. Alternatively, a fund manager can rely on Rule 506(b), which is the private placement exemption on which private equity fund managers have typically relied to raise capital for their funds. Due, in part, to the heightened regulatory scrutiny associated with Rule 506(c) offerings, virtually all private equity fund managers raise capital for their funds pursuant to Rule 506(b) and, as a result, this article will not delve into the specific requirements of Rule 506(c).

Rule 506(b) provides that an offering is deemed to comply with Section 4(a)(2) if (1) sales are made only to accredited investors, (2) the issuer does not engage in a general solicitation or advertising with respect to the securities offered and (3) the accredited investors acquire the securities for investment and not for resale. Notwithstanding the foregoing, it should be noted that Rule 506 permits the sale of securities to up to 35 non-accredited investors with additional disclosure to such investors. However, as a practical matter, private equity funds typically only accept accredited investors. In addition, Regulation D requires an issuer to file a Form D with the SEC within 15 days of the first sale of interests to US investors.

An additional requirement implicated in connection with a Rule 506 offering is compliance with the ‘bad actor’ rules set forth in Rule 506(d) of Regulation D. These rules disqualify securities offerings that involve certain felons and other bad actors from relying on Rule 506 of Regulation D where an issuer or specified covered persons have had a disqualifying event in the past.

Very generally, accredited investors are natural persons with a net worth (excluding the value of their primary residence) of US$1 million and entities with total assets of US$5 million.

Although the list of covered persons is too long to set forth in this footnote, covered persons include (1) the issuer seeking to sell securities under Rule 506, (2) any director, executive officer or other officer participating in the offering, (3) any beneficial owner of 20 per cent or more of the issuer’s voting equity securities and (4) any investment manager to an issuer that is pooled investment fund.

Disqualifying events include, among other things, criminal convictions, final orders of certain state and federal regulators, SEC disciplinary orders and SEC stop orders.
Manner of offering

One of the more significant requirements of Rule 506(b) is the prohibition on general advertising and solicitation. Essentially, this requires that the fund manager must have a substantive pre-existing relationship with a potential investor in order to solicit such investor. In other words, the fund manager must have adequate knowledge of that offeree’s financial circumstances and sophistication to establish that he or she is an eligible investor for the offering. A private equity fund manager can establish this level of relationship with a prospective investor in one of two ways. A representative of the fund manager might approach a prospective investor and inquire about the investor’s financial circumstances and sophistication. As part of this process, the fund manager will request that the investor complete a questionnaire that contains various questions seeking to identify the investor’s financial net worth and general level of sophistication with respect to investment matters. After continuous contact with the prospective investor for a sufficient period of time (the SEC has provided guidance indicating that a 45-day period could be sufficient), the fund manager may distribute offering materials for a fund to such investor without violating the prohibition on general advertising and solicitation. Alternatively, the fund manager may engage a placement agent to solicit prospective investors with whom the fund manager does not have a substantive pre-existing relationship. By doing so, the fund shall be deemed to have a substantive pre-existing relationship with any prospective investor with whom the placement agent has such a relationship. Although this is beyond the scope of this article, it should be noted that to the extent a US registered broker-dealer is engaged by a fund manager to solicit investors on behalf of a fund, the rules of the US Financial Industry Regulatory Authority will apply to the offering and will need to be considered.

Section 15 of the US Securities Exchange Act of 1934 (the Exchange Act) prohibits any person from engaging in the business of acting as a broker or a dealer unless such person is registered with the SEC as a broker-dealer or an exemption from such registration is available. If a private equity fund sells its securities to US persons directly, rather than through a placement agent that is a registered broker-dealer, the question arises whether anyone acting on behalf of the fund needs to register with the SEC as a broker-dealer. Rule 3a4-1 of the Exchange Act provides a non-exclusive safe harbour from such registration if certain requirements are met. Although the precise analysis under Rule 3a4-1 can be complex, very generally, if the persons acting on behalf of the fund (which may be officers and directors of the investment manager or general partner of the private equity fund) (1) are not subject to a statutory disqualification from acting in such capacity, (2) provide services to the fund manager other than solely capital-raising assistance, (3) are not affiliated with a registered broker-dealer and (4) do not receive commissions or other sales-based compensation for the sale of interests in the fund manager’s private equity funds, the fund manager may elect to take the position that it can rely on the Rule 3a4-1 safe harbour. This is a very fact-specific analysis so fund managers and their counsel will need to carefully consider the factual circumstances before making this determination.

12 Examples of general advertising and solicitation include, without limitation, cold calling or mass mailing or communications published in any newspaper, magazine or similar media, or broadcast over television or radio.
iv Solicitation of non-US investors

To the extent the US fund manager is seeking to solicit non-US investors for its non-US private equity fund, Regulation S (instead of Regulation D) becomes the applicable US offering rule with which the fund manager must comply. With respect to the Section 5 prohibition referenced in footnote 8, through the Regulation S safe harbour, the SEC generally takes the position that the registration requirements of the Securities Act do not apply to offers and sales of securities made outside of the United States when such offers and sales are made with only incidental US contacts and are made in a way reasonably designed to preclude the redistribution of the securities in the United States. A typical non-US private equity fund complies with Regulation S by satisfying the requirements of Rule 903(a) under Regulation S, which requires that the offer or sale is made in an offshore transaction and no directed selling efforts are made in the United States by the issuer or any person acting on behalf of the issuer.

v Negotiation of legal terms

Given investors in a private equity fund are often locked into the investment in the fund for at least 10 to 12 years without any right to redeem from the fund, the governing document of a private equity fund is typically heavily negotiated and detailed. As a result, prospective investors often focus closely on the corporate governance aspects of the overall arrangement. For instance, (1) do the investors have an ability to suspend or terminate the fund manager’s ability to make new investments, (2) do the investors have a right to terminate the fund or remove the general partner of the fund (either for cause or without cause) and (3) is there an advisory committee comprised of representatives of limited partners that looks after the interests of the investors? There are often many discussions around these general concepts. Investors also focus on the economic terms offered by the fund. In addition to the management fee and carried interest mechanics, which are often scrutinised, investors also analyse the limited partners’ obligations to return distributions to the fund (i.e., a limited partner giveback provision) and the general partner’s obligation to return any carried interest it received in excess of what it was entitled to receive under the private equity fund’s partnership agreement. There are a multitude of other concepts covered in negotiations with investors. Some of these concepts are derived from private equity principles developed by the Institutional Limited Partners Association (ILPA). It would be prudent for fund managers seeking to raise capital to familiarise themselves with these ILPA principles and compare their fund terms and conditions against those recommended in the ILPA principles.

III REGULATORY ASPECTS

i Regulation of the fund

A typical private equity fund would fall within the definition of an investment company because the majority of its assets are investment securities for purposes of the US Investment Company Act of 1940 (the Investment Company Act). However, private equity funds generally have two exceptions to investment company status on which they can rely. One is set

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13 An offshore transaction is a transaction in which the offer or sale of the fund’s interests is made to a person outside of the United States and the buyer is offshore at the time of the origination of the buy order.

forth in Section 3(c)(1) of the Investment Company Act (a fund relying on Section 3(c)(1), a ‘3(c)(1) Fund’) and the other is set forth in Section 3(c)(7) of the Investment Company Act (a fund relying on Section 3(c)(7), a ‘3(c)(7) Fund’). A 3(c)(1) Fund must not make or propose to make a public offering of its securities (e.g., offering its securities pursuant to Rule 506(b) or 506(c) of Regulation D would not be a public offering) and must not have more than 100 beneficial owners. While a 3(c)(7) Fund does not have a numerical limit on the number of beneficial owners it may have under the Investment Company Act, all of its beneficial owners must be ‘qualified purchasers’.15 A 3(c)(7) Fund must also not make or propose to make a public offering of its securities. Although beneficial ownership by an entity would typically be deemed beneficial ownership by a single person, it should be noted that the Investment Company Act and guidance issued thereunder contain ‘look-through’ rules that would require one to disregard the investing entity and analyse the entity’s underlying beneficial owners for purposes of determining whether the private equity fund has more than 100 beneficial owners or whether the fund is owned exclusively by qualified purchasers.

ii Regulation of the fund manager

General rule regarding investment adviser registration

The investment manager of a private equity fund will likely fall within the definition of an ‘investment adviser’16 under the US Investment Advisers Act of 1940 (the Advisers Act). If the fund manager is not registered with the SEC as an investment adviser, the fund manager will also need to consider whether it needs to register with the applicable state or states in which it conducts its investment advisory activities. Finally, to the extent the fund manager utilises certain derivatives or other commodity interests in connection with its business, it will need to determine whether it may need to register with the US Commodity Futures Trading Commission (CFTC) as a commodity pool operator or commodity trading adviser, or as both.

Private fund adviser exemption

The SEC exempts from registration as an investment adviser an investment adviser that provides investment advice solely to private funds17 and that has less than US$150 million in regulatory assets under management18 in the United States. For US-based investment advisers, all of their regulatory assets under management generally will count towards this US$150 million threshold. However, in the case of an investment adviser with a principal office and place of business outside of the United States (a non-US adviser), the exemption is available as long as all of the non-US adviser’s clients that are US persons are ‘qualifying

15 The definition of ‘qualified purchaser’ is set forth in Section 2(a)(51)(A) of the Investment Company Act and includes, among other things, a natural person with an investment portfolio of US$5 million and an institution with an investment portfolio of US$25 million. There are special rules in this regard for trusts.

16 An ‘investment adviser’ is defined as a person that (1) for compensation, (2) engages in the business of advising others, (3) as to the advisability of investing in, purchasing, or selling securities. See Section 202(a)(11) of the Advisers Act.

17 A ‘private fund’ is defined as any issuer that would be an investment company under the Investment Company Act but for the exceptions set forth in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

18 The term ‘regulatory assets under management’ is the sum of the value of all securities portfolios with respect to which the adviser provides investment advisory services.
private funds\(^{19}\) and the non-US adviser manages less than US$150 million in private fund assets from a place of business in the United States. In other words, so long as a non-US adviser has no place of business in the United States and to the extent its only clients that are US persons are private funds, it will not be required to register under the Advisers Act regardless of the amount of private fund assets under management attributable to US private funds.

**Foreign private adviser exemption**

There is also an exemption from SEC registration under the Advisers Act specifically applicable to ‘foreign private advisers’. A foreign private adviser is an investment adviser that: (1) has no place of business in the United States; (2) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; (3) has aggregate regulatory assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than US$25 million; and (4) neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to an investment company registered under the Investment Company Act or to a company that has elected to be treated as a business development company pursuant to Section 54 of the Investment Company Act. With respect to this exemption, the term ‘place of business’ means an office at which the investment adviser regularly provides advisory services, solicits, meets with or otherwise communicates with clients, and any location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

**Venture capital fund exemption**

A fund manager that provides investment advice exclusively to venture capital funds can rely on a separate exemption from registration as an investment adviser. To qualify for this exemption, each fund advised by the fund manager must qualify as a venture capital fund,\(^{20}\) which is a private fund that (1) represents to investors that it pursues a venture capital strategy, (2) does not provide investors with redemption rights or other similar liquidity rights except in extraordinary circumstances, (3) holds, immediately after the acquisition of any asset, other than ‘qualifying investments’\(^{21}\) or short-term holdings, no more than 20 per cent of the amount of the fund’s aggregate capital contributions and uncalled committed capital

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19 A ‘qualifying private fund’ means any private fund that is not registered under Section 8 of the Investment Company Act and has not elected to be treated as a business development company pursuant to Section 54 of the Investment Company Act.

20 It should be noted that a fund manager relying on the venture capital fund adviser exemption may also advise one or more investment vehicles licensed by the Small Business Administration, otherwise known as SBICs, without running afoul of this exemption.

21 A ‘qualifying investment’ is generally an equity investment in a qualifying portfolio company. A ‘qualifying portfolio company’ is any company that: (1) at the time of any investment by the venture capital fund, is not a reporting company or foreign traded and does not control, is not controlled by, or is not under common control with another company directly or indirectly, that is a reporting company or foreign traded; (2) does not borrow or issue debt obligations in connection with the fund’s investment in such company and distribute to the venture capital fund the proceeds of such borrowing or issuance in exchange for the venture capital fund’s investment; and (3) is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by Rule 3a-7 under the Investment Company Act, or a commodity pool.
(total capital) in assets (other than short-term holdings) that are not qualifying investments,
(4) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage
in excess of 15 per cent of the fund’s total capital, and any such borrowing, indebtedness,
guarantee or leverage is for a non-renewable term of no longer than 120 calendar days (except
for certain portfolio company guarantees that may exceed this time limit, as described below),
and (5) is not registered under the Investment Company Act and has not elected to be treated
as a business development company.

**State regulation**

To the extent the fund manager is able to avail itself of an exemption from SEC registration,
the fund manager will likely need to consider whether it is obligated to register with any state
in which it conducts its advisory activities. This will require a careful analysis of the applicable
state securities laws to determine whether there may be an exemption from such registration
or whether registration is required. Some states may not require registration of private fund
managers or may only require registration once the number of funds such manager manages
exceeds a certain threshold.

**CFTC regulatory status**

Although a private equity fund manager is unlikely to utilise futures like that of a hedge
fund manager, a private equity fund manager may seek to utilise certain types of derivative
instruments (e.g., swaps) that hedge risks at the fund level such as foreign exchange risk or
interest rate risk. To the extent these instruments constitute commodity interests for purposes
of the rules and regulations of the CFTC, the private equity fund manager will have to
to consider whether it is required to register with the CFTC as a commodity pool operator
(CPO) or a commodity trading adviser (CTA), or as both, or whether it can avail itself of
an exemption.

To the extent the private equity fund manager can utilise commodity interests within
a specified *de minimis* exemption, the fund manager can avoid registration with the CFTC
as a CPO and CTA. This *de minimis* exemption from CPO registration is set forth in
CFTC Rule 4.13(a)(3) and requires that (1) the private equity fund is privately offered,
(2) the private equity fund only engages in a *de minimis* amount of trading in commodity
interest positions,22 (3) the private equity fund is not marketed as a vehicle for trading in the
commodity futures or commodity options markets and (4) the investors of the private equity
fund are non-US persons (as defined in the CFTC regulations) or accredited investors (as
defined in Regulation D of the Securities Act).

With respect to non-US fund managers, there are additional CPO exemptions that may
be applicable to such managers. These exemptions are set forth in CFTC Rules 3.10(c)(3),
30.4(c) and 30.5. CFTC Rule 3.10(c)(3) is generally the most popular CPO exemption
for non-US fund managers because it is the only one of these exemptions that permits the
private equity manager to engage in the trading of commodity interests on US exchanges,

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22 To meet the *de minimis* exemption, the commodity interest positions held by the private equity fund
must (1) be established with aggregate initial margin, premiums and required minimum security deposit
for retail forex transactions not exceeding 5 per cent of the portfolio’s liquidation value or (2) have a net
notional value not exceeding 100 per cent of the portfolio’s liquidation value, in each case, after taking
into account unrealised profits and unrealised losses on any such positions the private equity fund has
entered into.
which, given the depth of the US trading markets, is generally preferred. To qualify for CFTC Rule 3.10(c)(3), (1) the CPO must be located outside of the United States, (2) the private equity fund and its investors must all be located outside of the United States and (3) the private equity fund trades commodity interests on US exchanges.

To the extent a fund manager can avail itself of an exemption from CPO registration, the fund manager can often find an exemption from CTA registration as well. One common exemption is set forth in CFTC Rule 4.14(a)(5), which provides an exemption from CTA registration if the fund manager is exempt from registration as a CPO and such fund manager’s ‘commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so exempt’.

To the extent a fund manager is unable to satisfy an exemption from either CPO or CTA registration, the fund manager will likely be required to register with the CFTC in such capacity. This generally will mean that such fund manager will need to operate each private equity fund it manages that is outside of any applicable CFTC exemption pursuant to CFTC Rule 4.7. CFTC Rule 4.7 is only able to be utilised by registered CPOs and it allows a registered CPO to comply with less burdensome disclosure, record-keeping and reporting requirements than would otherwise apply in light of the fact that the investors in the commodity pool are more sophisticated (i.e., ‘qualified eligible persons’).

**Current regulatory considerations**

The recently passed Tax Cuts and Jobs Act in the United States imposes a three-year holding period for eligibility for investment managers to be taxed at long-term capital gains rates on their carried interest (i.e., the share of partnership profits received by a fund manager in an investment fund). If this three-year requirement is not met, the carried interest allocation would be taxed as short-term capital gain subject to a top marginal rate of 37 per cent. It is currently uncertain how this will impact the private equity fund industry. Many private equity fund managers have historically held many (if not most) of their investments for at least three years. Others may consider whether there is any way to ameliorate this tax consequence through adjustments to the fund’s governing documentation.

At the state level, the governor of the state of New York has recently proposed a 17 per cent ‘fairness fix’ tax on hedge fund and private equity managers’ compensation. This tax is intended to reflect the difference between a 20 per cent federal rate that such earnings often qualify for and the top 37 per cent rate it would face if it were treated as ordinary income. Because this measure would take effect only if Connecticut, Pennsylvania, Massachusetts and New Jersey enact similar legislation, it is unclear whether this proposal ultimately will be implemented.

At the federal regulatory level, the SEC recently released its examination priorities with respect to investment advisers. Although no one expects the SEC to ignore private equity fund managers, there does seem to be a move away from a focus on private fund managers to protection of retail investors and these inspection priorities are consistent with that construct.

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23 ‘Qualified eligible persons’ includes, among other categories of investors, qualified purchasers.
IV OUTLOOK

The private equity fund industry has been through a great deal in the past 10 years or so. There was a financial crisis in 2008–2009, followed by a global increase in regulation. This has resulted in the obligation of many private equity fund managers to register with the SEC and, in some cases, the CFTC, as well as regulators in other jurisdictions, and their policies and procedures have been scrutinised through routine examinations. Ultimately, private equity fund managers have effectively weathered these developments and have generated high returns over the past decade. While valuations in the private equity market are perceived as high by some investors, investors continue to seek out private equity funds for their ability to provide protection when the economy or the public markets suffer a downturn. Accordingly, private equity fund managers will likely continue to have success raising capital for their funds while utilising the significant amount of dry powder they hold in reserve should the inevitable pullback in the markets appear.
Part II

INVESTING
Chapter 1

ARGENTINA

Diego S Krischcautzky and María Laura Bolatti Cristofaro

I OVERVIEW

Private equity activity in Argentina flourished in the 1990s when it received a large portion of the investments made in the Latin American region. However, at the beginning of the 2000s, the Argentine economy crashed and has since then dipped in and out of financial crises. In Argentina, politics and economic activity tend to be more intertwined than in other places, and they influence each other significantly. As a result, M&A and private equity tend to slow in times of political or economic change or instability.

Currently, Argentina is, once again, undergoing a deep economic crisis. After a slow recovery in 2016 and 2017, the hardships began in the first quarter of 2018 when the country lost access to the international, voluntary credit markets it had regained in late 2015 and had to ask for support from the International Monetary Fund (IMF), which approved the largest loan it has ever granted (US$57 billion). The crisis translated into two consecutive years of recession, high inflation, steep devaluation, unemployment growth and political uncertainty.

The new economic scenario had an obvious impact on the results of the primary elections of August 2019, which function as a strong indicator of the outcome of the general elections (which took place in late October 2019). In the primary elections, it became clear that Alberto Fernández and two-time former president Cristina Fernández de Kirchner would eventually become president and vice-president, respectively. This meant, in the general view, that the country would step away from an orthodox-leaning economic approach (as a result of the IMF agreement), to return to a heterodox economics-oriented administration. Also, even before the elections took place, international creditors and investors cast doubts on the country’s capacity to repay its large sovereign debt, including the IMF loan.

The certainty that the country would be run by a new government after December 2019 created additional volatility, which led the then-incumbent administration to reinstate foreign exchange restrictions in an attempt to control the depreciation of the Argentine peso.

In this sense, on September 2019, the Executive Branch and the Argentine Central Bank (BCRA) issued regulations establishing the obligation on Argentine exporters to transfer and convert foreign currency proceeds to Argentine pesos in the Argentine foreign exchange market. Such regulations also limited the ability of both Argentine and non-Argentine residents to purchase foreign currency with Argentine pesos in the Argentine foreign exchange market and transfer it abroad. Most importantly, these regulations also established

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the requirement for companies to obtain BCRA’s prior approval before purchasing foreign currency to pay dividends outside of Argentina, although these restrictions were partially relaxed at the end of January 2020.

The government also extended, unilaterally, the payment dates of foreign and local currency-denominated debt, giving a clear signal that Argentina was in high financial stress.

On 27 October 2019, the Fernández formula won the general elections and took office in early December 2019. Shortly after the change of government, a bill was passed by the Congress declaring the economic emergency and vesting the president with several extraordinary powers for 180 days. The bill also created a 30 per cent tax on the purchase of foreign currency for savings, tourism and other purposes and repealed an automatic inflation-linked adjustment formula for retirement pensions. All of these measures, according to government officials, were aimed at facilitating the restructuring of the sovereign debt and keeping public spending under control.

At the time of writing, the restructuring of the sovereign debt is probably the biggest challenge the new government faces.

### Deal activity

Private equity investments increased in Argentina during 2018 on a year-on-year basis, although it remained slow in light of its potential.

The Latin American Venture Capital and Private Equity Association (LAVCA) reported 29 deals during 2018 for a total investment of US$567 million. These figures include the US$190 million investment by Riverwood Capital and Blackstone in telecommunications provider Metrotel and the US$150 million investment by Lone Star Funds in oil and gas company San Antonio International. As for venture capital investment, LAVCA reports a total of 19 investments during 2018 for a total of US$84 million, including the raising of US$34 million in Series B for fintech Ualá and a US$31 million Series C for digital security company Onapsis.2

Although full year statistics are not yet available for 2019, the Argentine Association of Private Equity, Venture and Seed Capital’s industry report shows that there were no significant variations in private equity activity between the first part of 2018 and the same period of 2019.3 However, although the number of private equity transactions during this period was similar in both years, committed investments doubled from US$445.46 million in the first half of 2018 to US$891.11 million in the first half of 2019. Having said this, the increase in the invested amounts in the first half of 2019 was mainly driven by the closing during this period of the acquisition by Advent International of the payment processing company Prisma Medios de Pago for US$724 million, which divestment from the prior owners (a group of local banks) was mandated by the Argentine Antitrust Commission.

The political uncertainty and the economic crisis affected activity during the second half of 2019. Despite this, we saw some transactions of significance. For example, in November 2019, Ualá, a fintech, raised US$150 million in a round led by SoftBank and Tencent, and in December 2019, commercial earth imaging company Satellogic,

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2 2019 LAVCA Industry Data & Analysis Update on Latin American PE & VC.

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headquartered in Buenos Aires, announced it had raised US$50 million to help scale up its satellite constellation. Funding came from Tencent, Brazilian fund Pitanga and new investors, including IDB Lab, the ‘innovation laboratory’ of the Inter-American Development Bank.4

This deal illustrates that the Argentine tech environment is quite active, with prospects for venture capital deals in this area looking positive for the upcoming years.

Private equity in Argentina is mainly driven by foreign (mostly regional) private equity firms and a relatively small number of local players. Local private equity firms are smaller in size than foreign private equity firms. Major international players such as TPG, KKR and Blackstone do not have significant direct presence. Riverwood Capital, Victoria Capital Partners and other major regional funds do have investments in local companies, although mostly with regional reach.

Given the lack of specific regulations regarding the creation of private equity funds, in general funds are raised outside the country and invested through foreign special purpose vehicles (SPVs).

ii Operation of the market

Management equity incentive arrangements in the local market follow international standards, in general. These include the payment of bonuses and the granting of stock option plans, restricted stock units or similar. Normally, these incentives are a linked to a foreign issuer, which acts as a holder of the local company.

Sale processes in Argentina generally follow international practices. However, since Argentina’s capital market is relatively underdeveloped, most of the transactions relate to the acquisition of unlisted companies or assets.

After identifying the target, a due diligence process is normally conducted. The parties may or may not sign a letter of intent, memorandum of understanding or similar.

Once the due diligence is finalised, the transaction documents are negotiated. Transactions may be structured as share deals or asset deals. In the case of share deals, it has become increasingly common for purchasers to acquire at least part of the equity interests by making contributions in the target company for newly issued shares, rather than acquiring existing shares. This is usually because certain funds need to stay at the target entity level. The preferred structure will mainly depend on the parties’ goals and a detailed case-by-case analysis of the efficiencies and inefficiencies of the different structures.

Transactions may also be envisioned with simultaneous or deferred signing and closing. This will usually depend on the conditions to closing that the parties may establish and any required prior consents to which the transaction could be subject either by law or contractually.

Having said this, depending on the industry in which the target operates, prior approval or post-closing filings may be required to implement the transaction.

Also, provided it entails a change of control, the transaction could be subject to merger control. There is currently a post-closing merger control system in Argentina. Therefore, if required, obtaining antitrust clearance is usually reflected as a post-closing obligation. Pursuant to a relatively recent amendment in applicable law, however, Argentina’s merger control system should switch to a pre-closing system in the near future.

In the case of listed target companies, the Capital Markets Law and the rules of the Argentine Securities Exchange Commission (CNV) will apply. Should the transaction entail a change of control in terms of the CNV rules, the purchaser will be required to issue a mandatory tender offer in favour of the remaining shareholders of the company, as provided in the CNV rules. In terms of mechanics, the tender offer needs to be launched immediately after a binding agreement is reached.

Asset transfers, if considered as the total or partial transfer of a business unit, will make the acquiring company jointly and severally liable with the seller for all pre-closing liabilities of the business. Likewise, asset deals are not different from share deals in terms of exposure to pre-closing liabilities. The Bulk Transfer Law, and other regulations, establish proceedings that, if fully followed, limit the successor company’s liability for pre-closing periods (commercial liabilities and certain liabilities regarding federal taxes only). The Bulk Transfer Law proceeding entails publishing notices in favour of creditors and, if fully followed, notifying the Argentine tax authorities of the transfer. The fact that the publicity of the process may increase the seller’s exposure and does not limit all pre-closing liabilities usually acts as a disincentive to follow the Bulk Transfer Law proceeding when solvency of the seller is not at stake or adequate guarantees are provided to the buyer.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Private equity funds are not subject to a specific legal framework in Argentina. Neither are the acquisitions of control or minority interests, which are subject to the same rules applicable to any M&A transaction.

In general, for the reasons cited above, private equity firms, even when formed by Argentine residents, create foreign vehicles for investment outside Argentina (SPVs) in which they remain as general partners in charge of the administration, while incorporating limited partners. Investment and shareholders’ agreements ruling the relationship between both types of partners are usually also subject to foreign law and jurisdiction.

Should the SPV be set up in Argentina, the relationship between the partners will be subject to the rules applicable to the investment vehicle form chosen by the parties and the terms of any shareholders’ agreement in place. Since there are certain mandatory rules in Argentina for the different forms of vehicle, it is generally advisable that shareholders’ agreements in these cases be governed by Argentine law.

The most frequently used corporate vehicles in Argentina are as follows:

a corporations (SA);

b sole shareholder corporations (SAU), which are very similar to SAs but can be set up by one shareholder only and are, therefore, subject to certain stricter rules;

c limited liability companies (SRL), which are sometimes preferred by US clients since they consider them as check-the-box entities; and

d in the past couple of years, simplified corporations (SAS), a new corporate type created in 2017 by the Entrepreneurship Law. SASs can be set up by one shareholder only, similar to SAUs, but are subject to less scrutiny from the registry, give shareholders a greater degree of flexibility to set rules and have lower maintenance costs.

Argentine law also includes partnerships limited by shares (SCA) within the corporate vehicles available. The SCA is the vehicle that better reflects the structure of private equity
vehicles, since it distinguishes between partners in charge of the management of the vehicle (general partners) and mere equity partners (limited partners). However, in practice, this type of company is rarely used.

While in the case of SAs, SAUs, SRL and SASs, the general rule is that all partners limit their liability to the contributions made to the company, with limited exceptions (e.g., cases in which a judge may consider that there are reasons to pierce the corporate veil), in the case of the SCA, limited partners limit their liability to their contributions to the SCA, but general partners have unlimited liability for the company’s operations.

To become a shareholder of a local corporate vehicle a foreign entity would need to have previously appointed a representative in Argentina and registered with the public registry of the relevant Argentine jurisdiction (in the city of Buenos Aires, the IGJ) and with the Argentine federal tax authorities.

If the SPV is set up outside Argentina and subsequently acquires shares of an Argentine company, the SPV itself should have previously obtained those registrations.

For many years, registering a foreign entity in the city of Buenos Aires entailed a lengthy process because the IGJ requested foreign entities to provide evidence that their main corporate activities were conducted outside Argentina. The former administration relaxed these requirements and the documentation to be filed by foreign companies is now very straightforward. The new administration has announced tighter control on legal foreign entities with focus on offshore companies.

Argentine law does not generally restrict the acquisition of equity interests in Argentine companies by non-Argentine residents.

Despite this, as mentioned above, certain limitations, prior approvals or post-closing filings may exist in connection with certain industries. Also, restrictions may exist in connection with the acquisition by foreigners of rural or border lands, which would be analysed on a case-by-case basis depending on, among other things, the jurisdiction of the land within Argentina and the particularities of that jurisdiction.

In addition, while there is no prohibition to invest in Argentina from certain jurisdictions, foreign entities incorporated in jurisdictions considered as non-cooperative on fiscal transparency or in the fight against money laundering and terrorism financing will be subject to further scrutiny when submitting an application to register before the IGJ.

There are also some negative tax impacts associated with channelling investments in Argentine companies through a vehicle incorporated in any jurisdiction considered as non-cooperative on fiscal transparency or in a nil or low tax jurisdiction, as defined by the Income Tax Law. In principle, equity contributions in Argentine companies are tax neutral for the shareholder and the Argentine entity receiving the funds. However, the Argentine Tax Procedure Law sets forth a legal presumption by which incoming funds from those jurisdictions will be deemed to be an ‘unjustified equity increase’ on the Argentine entity, no matter the nature of the operation involved. Unjustified equity increases on the Argentine entity are subject to income tax and value added tax, and in both cases, the tax rates would be assessed on 110 per cent of the amount of funds transferred. Although Argentine residents may rebut such legal presumption, the standards required by the Argentine tax authority are difficult to meet.

In contrast, Argentina has entered into several double taxation treaties that could be beneficial for certain investors and should be taken into consideration when structuring a potential transaction.
Most of the private equity transactions in Argentina consist of the acquisition of non-listed entities, and transactions are implemented as per usual international terms. In terms of the transaction documents, the higher the interest acquired, the more bargaining power the purchaser will have. If acquiring control, the purchaser will be interested in reducing as much as possible the minority shareholders’ rights after closing. If seeking a minority investment, the purchaser will seek to obtain as much control of the investment as possible, fixing aggravated majorities for certain sensitive matters, securing the appointment of a certain number of board members, etc.

In terms of governmental approval, transactions involving changes of control could be subject to merger control in Argentina, unless the transaction falls within any of the exemptions set forth under the Antitrust Law.

Also, the acquisition of control of public companies in terms of the Capital Markets Law and the CNV rules could make it necessary to follow a mandatory tender offer process, as mentioned in Section I.ii.

Whatever the percentage of shares of a local company acquired by the SPV, private equity firms usually pay special attention to exit provisions so as to ensure that the investment can be divested at a given time.

The most typical form of exit in Argentina is through a sale to an investor. In the case of the investment in Prisma discussed in Section I.i, some local media conveyed that Advent International may be interested in exiting through an initial public offering, but this is not the most common practice.

ii Fiduciary duties and liabilities

In general, pursuant to the Companies Law, directors are subject to a duty to act loyally towards the company and its shareholders and to carry out their functions with the diligence of a good business person. Should the SPV be set up in Argentina or if the SPV is set up abroad but appoints a director in an Argentine target entity, these standards will apply. The concept of loyalty embraces the obligation to meet the standard of an ‘honest person’ and to defend the interests of the company. In this sense, a director cannot compete with the company in furtherance of his or her own interest where such interest conflicts with the interest of the corporation. The good business person standard is applied to the particular circumstances of each activity undertaken by a director and is an objective standard. This standard requires, among other things, that directors possess certain qualifications (e.g., technical knowledge, expertise) and that they perform their responsibilities in accordance with such qualifications. Failure to meet the foregoing standards will make the directors unlimitedly and severally liable for any damage caused.

In addition, directors are personally and unlimitedly liable to the company, the shareholders and third parties for non-performance of their duties, violation of the law, by-laws or regulations, or for fraud, abuse of power or gross negligence.

III YEAR IN REVIEW

Recent deal activity

During 2018 and 2019, the hottest areas for private equity investment in Argentina were telecommunications, fintech and other areas of technology.

The biggest private equity transaction of the first part of 2019 was the acquisition of 51 per cent of Prisma Medios de Pago by the Boston-based private equity firm Advent
International for US$724 million. Prisma is the leading payment company in Argentina and one of the largest in Latin America, operating in 15 countries, processing more than 7 billion transactions per year and hiring more than 1,300 individuals.\(^5\)

The transaction was part of a divestment commitment undertaken by the shareholders of Prisma (14 banks and Visa Inc) in the context of an investigation initiated against them for monopolising the credit cards and electronic payment market.\(^6\)

At the beginning of the process, bidders showed high interest in the company. However, the economic instability made some bidders lose interest. Certain local analysts have conveyed that the Prisma shareholders considered the valuation at which shares were sold as ‘lacklustre’ and that they would probably have waited for a better offer had they not had a deadline to divest by January 2019. In spite of this, Prisma’s chief executive officer himself said that the deal was probably one of the largest equity transactions in Argentina in the past 30 years.\(^7\)

As regards the economic terms of the transaction, according to public information, it was agreed that 60 per cent of the price would be paid at closing, while the balance will be paid within a five-year term, and that 70 per cent of the payment would be made in US dollars with the balance to be paid in Argentine pesos.\(^8\) The deal included the granting of certain guarantees to secure payment of the deferred portion of the price.

It is worth mentioning that, during the previous administration, the Argentine Congress created the Knowledge Economy Promotional Regime aiming at promoting economic activity that applies the use of knowledge and the digitalisation of information (supported by progress in science and technology) to obtain goods, provide services or improve processes. The regime grants certain tax and social security advantages to its beneficiaries.

To qualify as part of the Knowledge Economy Promotional Regime, companies must register before the National Registry of Beneficiaries and meet at least two of the requirements set forth in the applicable regulations. The requirements include that the company performs continuous improvements in the quality of services, products or processes, invests in research and development activities for a certain period of time, or a certain minimum percentage (which will vary depending of the kind of activity and the beneficiary) of its exports of goods or services derive from the performance of any of the promoted activities.

Companies meeting at least two of these requirements will obtain certain tax benefits, including:

\(a\) fiscal stability (the Argentine total tax burden at a federal level will be determined at the moment the beneficiary requests its registration and will not be modified thereafter);

\(b\) 15 per cent reduction of income tax;

\(c\) reduction in social security contributions;

\(d\) exemption from value added tax withholdings or collection; and

\(e\) tax credit bonus equivalent to 1.6 times the amount payable as social security contributions that the beneficiary does not pay due to the benefit mentioned in point (c).

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\(^7\) id.

\(^8\) id.

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Each beneficiary must, however, pay an annual amount of up to 1.5 per cent of the total tax benefits granted under the Trust Fund for the Development of Entrepreneurial Capital regime.

The new administration would, in principle, maintain the Knowledge Economy Promotional Regime.

IV REGULATORY DEVELOPMENTS

No specific regulators have oversight of private equity transactions or firms in Argentina.

If the SPV or the target entity are incorporated in the city of Buenos Aires, the IGJ will, in principle, be the regulatory body with oversight of their operations. The role of the IGJ in potential transactions carried out by, or in connection with, registered local entities will depend on the type of vehicle involved. In the case of SA, SAU and SAS entities, for example, transfers of shares need not be filed with the IGJ. On the contrary, transfers of quotas of an SRL must be registered with the IGJ to become enforceable with regard to third parties. Periodical filings to be made with the IGJ will also vary depending on the corporate type.

Listed companies’ activities are subject to the supervision of the CNV.

Depending on the industry in which the target entity operates, it may also be subject to supervision of other governmental bodies (e.g., insurance companies are subject to the supervision of the National Superintendence of Insurance). This may include the request of prior authorisation to close a transaction.

In all cases, the approval of the Antitrust Commission may be required if the transaction involves a change of control.

V OUTLOOK

The economic situation and the fact that there has been a change in the government will very likely slow down private equity activity during the first part of 2020 and at least until there is more clarity on whether Argentina will be in a position to climb out of the recession and restructure its debt.

However, times of crises have proven to be times of opportunity, particularly for private equity funds.
I OVERVIEW

i Deal activity

Investments

In the large-cap segment (comprising deals with values above €100 million), deal count and total deal value decreased compared with a very busy 2018, with the acquisition by Blackstone of the European distribution business of CRH, a global construction materials group, with a reported deal value of €1.6 billion and the acquisition by Baring Private Equity Asia and TELUS International, Inc of CCC Holding GmbH, a business process outsourcing services provider, from Ardian, with a reported deal value of €951 million being the most prominent transactions.

In the mid-cap segment (comprising deals with values of between €10 million and €100 million), deal count and total deal value remained more or less on a par with 2018. Examples of mid-market deals include the acquisition by Silverfleet Capital of BOA CoreDux, the purified and flexible solutions division of the BOA Group; the acquisition by Deutsche Beteiligungs AG of Catalysts GmbH, an Austrian software development company, from founders Christian Federspiel and Christoph Steindl; the acquisition by VR Equitypartner of a majority stake in Signon Österreich, an Austrian company providing complex software applications for ticket and travel information systems, fleet management, asset management and control of logistics processes, from TÜV Süd; the acquisition by Triton and Abu Dhabi sovereign wealth fund ADIA of IFCO Systems, the leading global supplier of returnable packaging solutions for fresh food, from Brambles Limited; the acquisition by Waterland private equity portfolio company coeo Inkasso GmbH of debt collection agency KNP Financial Services GmbH, from founders Anton Moser and Wolfgang Hetlinger; the acquisition by Manzanita Capital Limited of a majority stake in Susanne Kaufmann Kosmetik GmbH, an Austrian skin care manufacturer, from Susanne Kaufmann and Beatrice von Thurn und Taxis; the acquisition by investment holding SPIE Deutschland & Zentraleuropa of Christof Electrics, an Austrian company active in the ICE industry sector; the acquisition by investment holding company Mutares of Q Logistics, an Austrian company active in transport logistics, from ÖBB (Austrian Federal Railways); and the acquisition by Battery Ventures LP and AED-SICAD of Dynamic Design GmbH, an Austria-based provider of software solutions for planning and management of telecommunication networks from Peter Egloff and Manfred Wetzlmair.

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1 Florian Cvak and Clemens Philipp Schindler are partners at Schindler Attorneys.
Venture capital activity (comprising deal values of €4 million and above) more or less remained on par with 2018 levels. Examples include a Series D round led by Farallon Capital, Adjuvant Capital, Hadean Ventures and Merck Sharp & Dohme for Themis Bioscience GmbH, an Austrian vaccine developer; a Series B round led by Felix Capital for Adverty, an Austrian company operating a cloud-based marketing analysis platform; Series B rounds led by eQventure GmbH for USound, an Austrian micro-speaker manufacturer, and SteadySense, an Austrian med-tech start-up; a Series A round led by EnBW New Ventures for Holo-Light, an Austrian–German augmented reality solutions provider; a Series A round led by DieBrückenköpfe for Medicus AI, an Austria-based med-tech start-up; a Series A round led by Uniqa Ventures, for bsurance, an Austria-based insurtech start-up; a Series A round led by Ringier Digital Ventures for CheckYeti, an Austria-based booking platform for outdoor activities; an investment by Volkswagen in a minority stake in Has-to-be, an Austrian e-mobility solutions developer; and an investment by Russmedia for a majority stake in jobiqo GmbH, an Austrian developer of job exchange software.

**Exits**

In the large-cap segment (comprising deals with values above €100 million), notable exits included the sale by KKR of ELL Austria GmbH, an Austria-based electric locomotive leasing solutions provider, to AXA Investment Managers and Credit Agricole Assurances SA, with a reported deal value of around €1 billion; the sale by Gilde Buy Out Partners of Powerlines Group GmbH, Europe’s leading independent supplier of electrification systems for infrastructure facilities, to French energy group ENGIE Ineo (transaction value not public); the sale by Bain Capital of a minority stake in Wittur-Group, a global leading supplier of components, kits and complete systems for the elevator industry, to Canadian Public Sector Pension Investment Board (transaction value not public); and the sale by OpCapita of NKD, a leading central European clothing retailer, to TDR Capital (transaction value not public).

In the mid-cap segment (comprising deals with values of between €10 million and €100 million), notable exits included the sale by Cudos Capital AG of Sky Plastic Group AG, an Austrian–Italian recycling company, to Schwarz-Group; the sale by Greenbriar Equity Group LP of a majority stake in Frauscher Sensor Technology Group GmbH, an Austria-based technology leader for solutions for wheel detection, axle counting and tracking in railway operations, to Delachaux SA; the sale by Welsh, Carson, Anderson & Stowe and AIM-Management of AIM Holding SCA, a leading provider of data management solutions for the financial industry to SimCorp; the sale by Gamma Capital Partners of a majority stake in the Siesta Group Schlafanalyse GmbH, an Austria-based company providing sleep tracking solutions, to PPRS Group; the sale by Speedinvest of a majority stake in Diagnosia, an Austria-based digital health company, to Österreichischer Apotheker-Verlag; and the sale by Speedinvest and TecNet Equity of indoor.rs GmbH, an Austria-based research and development company to Environmental Systems Research Institute.

**Operation of the market**

In buyout transactions, a private equity firm often involves future management in the due diligence process and the financial modelling. Typically, management is required (or at least given the opportunity) to acquire an interest in the target to ensure their commitment; however, foreign investors often find that local management is not as familiar with such arrangements as would be the case in other jurisdictions. Second-level senior management is sometimes also given the opportunity to invest in the same instruments (known as the
‘institutional strip’) acquired by the private equity firm to ensure that their interests are fully aligned. In the latter case, structuring options are, by definition, limited. Where management is required (or given the opportunity) to participate on target level, share options (in the case of stock corporations), restricted shares (for a description of the typical restrictions, see below), profit participation rights (a contractual arrangement that can be structured as equity or debt and, by contrast to shares, never confers voting rights), virtual shares (that is, a contractual arrangement giving the member a stock-like return) and phantom stock (that is, a contractual arrangement giving the member a bonus depending on operational performance) are the most common structures.

The detailed structuring of incentive packages is usually driven by the tax treatment of the benefits in the jurisdiction of residence. For example, management will have a strong interest in ensuring that any gains in relation to interests acquired are taxed as capital gains (and not as employment income). In that context, it is important that economic ownership of the incentive interest passes at the time of the grant (which in Austria depends on the management members’ entitlement to dividends (if any), voting rights and transfer restrictions). If economic ownership does not pass, the entire exit proceeds may be taxable as employment income. Management will typically also have an interest in limiting taxation at the time of the grant. Where economic ownership of the benefit concerned passes for arm’s-length consideration (usually management is asked to invest up to one year’s salary), there is no taxation of the grant (for Austrian tax residents). If there is no arm’s-length consideration, the grant is taxed as employment income. It should be noted that where the investor provides financing to the management, tax authorities may be more inclined to question whether economic ownership has passed for arm’s-length consideration. Since the tax treatment of incentive programmes is often somewhat unclear, it is advisable to seek a tax ruling on the related tax issues before deciding on a particular incentive structure.

Where actual shares are held by management, they are usually pooled (e.g., through a partnership) so that the investor technically only has one co-investor, and they are restricted. Such restrictions typically include a drag-along right of the private equity firm upon an exit and compulsory transfer provisions if the employment with the target group terminates. The consideration due in the case of a compulsory transfer will typically depend on the reason for termination (‘good’ and ‘bad’ leaver provisions), although structuring has become less aggressive in that regard given recent developments in employment law.

Auction processes are relatively common on the Austrian market. A standard auction process will typically be organised by an investment bank (or M&A adviser). As a first step, the investment bank will propose a shortlist of potential bidders and discuss that shortlist with its client. The investment bank will then invite the selected bidders to submit an indicative bid on the basis of an information package (including limited commercial, financial and basic legal information about the target company). Following evaluation of the indicative bids, the investment bank will invite the most promising bidders to conduct Phase I due diligence, for a period of about two to six weeks, and to submit a binding bid (usually together with a markup to a sale and purchase agreement circulated in the middle of the Phase I due diligence). Following evaluation of the binding bids, the seller will engage in negotiations with two to three bidders, which are then granted access to the Phase II due diligence material and red files (if any). The time required for the entire process varies significantly depending on the appetite for the target and the number of bidders involved. It can range from as little as two to three months up to six months or even more.
II LEGAL FRAMEWORK

i Acquisition of control and minority interests

A typical acquisition structure for an Austrian private equity transaction involves a set of holding companies (holdcos) incorporated in Luxembourg, the Netherlands or another tax-favourable jurisdiction, and an Austrian acquisition vehicle (bidco) that enters into the purchase agreement and ultimately acquires the shares. The funds will typically try to maximise leverage on the transaction. Where junior debt (e.g., mezzanine) is used, senior lenders will often require junior lenders to lend to a level higher in the structure to achieve not only contractual subordination (which is achieved by entering into an intercreditor agreement) but also structural subordination. The gap between bank debt and the agreed purchase price is then financed by the fund through a combination of equity and institutional debt. The amount of institutional debt that can be deployed is determined by thin-cap rules. While the law does not provide any guidance in this respect, debt-to-equity ratios of 3:1 to 4:1 are generally accepted by Austrian tax authorities.

On or shortly after completion of the share purchase, the target company is usually asked to accede to the financing documents on an exclusive lender basis (to avoid structural subordination of the financing banks to existing lenders of the target company), and to grant guarantees and security interests securing the acquisition debt as well as refinanced target company debt (if any). To the extent such guarantees and security interests secure repayment of the acquisition debt, they are of little commercial value, as they are only valid to the extent:

a. that the risk of default of the bidco and the risk of default of the target company (in cases where the security interest is enforced or the guarantee called) are acceptable, and that the granting of the security interest or guarantee will not put the target company at risk considering the risk of default of the bidco and the likelihood of recovery from the bidco based on the target company’s recourse claims against the bidco, where the security interest is enforced or the guarantee is called; and

b. the target company receives adequate consideration, which can either be a fee (in which case it should include a margin on top of the fee that would be charged by a bank in a comparable transaction) or an equivalent corporate benefit (e.g., access to financing that would otherwise not be available).

To preserve the validity of guarantees and security interests at least in part and avoid management (and supervisory) board liability, “limitation language” is typically included in the financing documents that limits the obligations of Austrian obligors to an amount and terms that are compliant with Austrian capital maintenance rules.

At the same time, the private equity fund will seek to implement a tax offset structure, which is aimed at offsetting interest expense at the bidco level with profit generated at the target company level. In principle, there are two methods to achieve this. The first method is to establish a tax group between the bidco and the target company. In such a tax group, the fiscal result of the bidco and the target company is consolidated at bidco level. If the aggregated fiscal result of the bidco and the target company is negative, the loss can be carried forward by the bidco to future periods. The formation of such a tax group requires a tax allocation agreement and an application to the competent tax office. The required minimum period of a tax group is fulfilled when three full fiscal years have lapsed. If the tax group is collapsed prior to the lapse of the three-year period, the group members are retroactively taxed on a stand-alone basis. A second method (which is sometimes discussed but rarely ever implemented because of the significant implementation risk it involves) is an upstream
merger of the target company into the bidco. Based on past decisions of the Austrian Supreme Court, it is pretty clear that where the bidco carries the acquisition debt for the purchase of the shares of the target company, a downstream merger of the bidco into the target company will not be registered. In certain exceptional cases, however, an upstream merger of the target company into the bidco may be feasible. The result of such an upstream merger would be that the shares in the target company pass to the bidco parent, interest expense on the acquisition debt could be offset against profit, and guarantees and security interests granted by the merged entity (holding the cash-generating assets) would not be subject to limitations under the Austrian capital maintenance rules (see above) and thus would be of greater commercial value to the financing banks. In particular, the last point is often of great interest to the financing banks involved, which is why this route is sometimes explored when a particular case supports the necessary arguments.

In a buyout transaction, the key legal documents include the acquisition documents: that is, one or more share purchase agreements with the seller and the financing documents (including agreements governing equity contributions and institutional debt coming from the fund, a senior (and mezzanine) facility agreement governing the debt financing coming from the financing banks, security documents and an intercreditor agreement governing priority among the various layers of debt). In addition, where the fund does not acquire all the outstanding share capital, governance documents are required, including a shareholders’ agreement, amended articles of association, and by-laws for the management board and supervisory board (if any). The main areas of concern in the governance documents are the fund’s right to appoint sponsor representatives to the supervisory board (or an observer to the supervisory board, or both), sponsor representative liability (see Section II.ii), a list of matters requiring the consent of the fund or the sponsor representative (which should be tailored such that there is no undue influence on the day-to-day business), anti-dilution provisions, a liquidation preference for the fund, and information and exit rights for the fund.

In most cases, the fund will also insist that at least senior management enters into a management equity incentive arrangement (see Section I), and that the management and all key personnel enter into service agreements acceptable to the fund.

ii Fiduciary duties and liabilities

Duties owed by a shareholder

Austrian courts have consistently held that shareholders owe a duty of loyalty to the company and to other shareholders, requiring shareholders to consider the interests of the company and the interests of other shareholders in good faith and in line with bonos mores. As a general matter, the scope of the duty of loyalty is more pronounced for closely held companies than for widely held companies, and differs from shareholder to shareholder depending on the ability of the relevant shareholder to make a difference. A majority shareholder may, for instance, be exposed to liability for a failure to appear and vote on a matter under certain circumstances, whereas a minority shareholder will not because his or her appearance (or vote) is of no relevance to the outcome anyway. The duty of loyalty may require a shareholder to appear and approve a proposal of the management board where the implementation of the proposal is necessary for the survival of the company (e.g., a capital increase, a capital reduction or an asset sale in a restructuring). The duty of loyalty does not, however, require a shareholder to provide further financing to a company in financial distress.

A private equity fund shareholder must also consider his or her duty of loyalty at the time of exit. As a general matter, an exiting shareholder must account for the legitimate
interests of the company and its shareholders when exiting his or her investment and prevent unnecessary harm (e.g., by excluding unpromising bidders, restricting competitors’ access to sensitive information and ensuring confidentiality). Accordingly, it is important that a professional process is put in place that complies with these requirements.

The private equity fund should also be aware that, in considering the duty of loyalty, Austrian courts have discussed concepts similar to the ‘corporate opportunities doctrine’, which, in essence, provides that whenever an opportunity falls within the scope of activity of the company, a shareholder is prohibited from exploiting that opportunity for his or her own advantage.

A violation of duties of loyalty may result in claims for damages, cease-and-desist orders or a challenge of the shareholder vote that violates those duties.

**Duties owed by members of the management and supervisory boards**

As a general matter, all members of the management and the supervisory board (if any) of an Austrian company, including any sponsor representatives, owe to the company (not the shareholders or any other constituents) the following duties:

- a duty of care, requiring members to exercise the level of care of a proper and diligent person in similar circumstances (which includes an obligation to be reasonably informed and articulate any concerns they may have);
- a duty of loyalty, requiring members to act in the best interest of the company and its shareholders and not in their own interest;
- a duty of confidentiality; and
- in the case of members of the management, a duty not to compete. Supervisory board members are not explicitly prohibited from competing with the company, but any competition will always be subject to scrutiny under the duty of loyalty.

Where a member of the management or the supervisory board is at fault, he or she is jointly and severally liable for any damages incurred by the company with all the other members at fault, unless the shareholders’ assembly has approved the measure resulting in the damage. A stock corporation may waive or settle its damage claims with an affirmative shareholder vote of 80 per cent after five years, or even before that with an affirmative vote of all shareholders. A limited liability company may waive or settle damage claims at any time, provided the waiver or settlement does not affect recovery against it by its creditors. A company may also take out directors and officers liability insurance for the members of the management board, in which case the associated expenses are treated as part of the remuneration of the relevant members.

A private equity fund should be aware that creditors of a joint-stock company (or, where insolvency proceedings have been opened, the administrator in those proceedings) can bring damages claims on behalf of the company against a member of the management or supervisory board to the extent that they cannot recover damages from the company in the following circumstances:

- a where the claim is based on provisions protecting the proper pay-in of share capital (including liability for unpaid capital contributions and liability for an unpermitted return of capital) or because of unpermitted payments made during insolvency (also in cases of slight negligence); and
- b in other cases, only where the relevant member was grossly negligent.
A waiver by the company or shareholder approval of the relevant measure does not exempt the fund from liability towards creditors (or the administrator).

Other sources of potential liability for the private equity fund involve:

a piercing the corporate veil, which is possible in the following circumstances:

• factual management by a shareholder, or the exercise of control over the management board by a shareholder (where a shareholder, while not formally appointed, factually manages the company or substantially controls the management board);
• undercapitalisation (only where there is an obvious imbalance between the risks of the business and the equity that is likely to result in a default of the company damaging creditors);
• intermingling of assets (where, based on accounting records, the assets of the company cannot be separated from the assets of the shareholder); and
• shareholder action putting the company at risk (where a shareholder takes action resulting in insolvency (e.g., acceleration of loans resulting in illiquidity or termination of a necessary patent));

b liability based on a breach of provisions protecting the proper pay-in of share capital (including liability for unpaid capital contributions, liability for unpermitted returns of capital and breach of financial assistance rules); and

c liability up to the amount secured where a shareholder has granted a guarantee or security interest securing a loan of a portfolio company in financial crisis (as defined in the Company Reorganisation Act), in which case the portfolio company can request the shareholder to pay to the creditor the amount secured for as long as it is in financial crisis (in which case, the recourse claim of the shareholder is suspended until the financial crisis is over). If the portfolio company pays the creditor, the portfolio company can request reimbursement from the shareholder.

III YEAR IN REVIEW

i Recent deal activity

See Section I.i.

ii Financing

The financing environment for buyout transactions more or less remained unchanged and is quite different for domestic market participants, who typically seek financing from domestic banks, and international financial sponsors, who are able to tap international banks (at least on large-cap deals). In the large-cap segment, debt-to-equity ratios are in the range of 50 per cent. In the mid-cap segment, debt-to-equity ratios tend to be more conservative but this depends on the type of business acquired. Smaller deals are sometimes financed with equity only.

Where leverage is employed on mid-cap transactions, there is usually only senior and institutional debt, as adding junior debt tends to add another layer of complexity that is often not supported by the limited transaction size. On large-cap transactions, layers of junior debt are often added to the mix. High yield is of little significance in Austrian leveraged buyout practice as the time and cost involved tends to be disproportionate to the gains on the pricing side. With an increased relevance of debt funds, new financing structures are being employed more often.
iii  Key terms of recent control transactions
See Section I.i.

iv  Exits
See Section I.i.

IV  REGULATORY DEVELOPMENTS

Domestic funds typically qualify as alternative investment funds (AIFs); as such, managers require a licence issued by the Austrian Financial Market Authority (FMA) under the Austrian Alternative Investment Manager Act (AIFMG). Most domestic funds qualify for the \textit{de minimis} exception for managers of small AIFs with assets of less than €100 million (where leverage is used) or less than €500 million (where no leverage is used), and as such do not require a licence but are only required to register with the FMA. Another benefit is that they are only subject to a very limited number of regulations under the AIFMG.

Licensed AIFMs do not require any additional licences or permits for their investment activities. Registered AIFMs may require a trade permit for asset managers.

i  Licensing processes

\textit{Licensed AIFMs}

To obtain a licence under the AIFMG, managers need to fulfil certain requirements.

a  A licensed AIFM must have a minimum capital of €125,000 if it is an external manager of an AIF. If the AIFM is an internal manager of an AIF, the minimum capital requirement is €300,000. In addition, the AIFM must have sufficient equity to cover 25 per cent of its annual running costs. Increased equity requirements apply if the assets under management exceed €250 million; in any case, the maximum capital requirement is €10 million. The persons tasked with the management of the AIFM must be sufficiently experienced and must pass an FMA ‘fit-and-proper’ test if requested to do so.

b  The AIFM must appoint at least two individuals as its managers.

c  In the application to the FMA, the AIFM must provide information on:

\begin{itemize}
  \item shareholders holding qualified participations in the AIFM (i.e., shareholdings exceeding 10 per cent);
  \item any closely related entities (i.e., a third party that holds a stake of more than 20 per cent of the AIFM or that controls the AIFM, or is controlled by the AIFM or in which the AIFM holds a stake of more than 20 per cent);
  \item its business plan;
  \item its remuneration, risk management, valuation, internal audit and conflict-of-interest policies;
  \item its investment strategies;
  \item a description of any competences delegated to third parties; and
  \item information on the contractual basis on which it manages its AIFs.
\end{itemize}

A decision by the FMA regarding the licence must be passed within three months of the applicant having provided all required information. If the AIFM intends to register an AIF as a European long-term investment fund, it has to apply to the FMA for prior approval.
Small AIFMs
Registered AIFMs may require a trade licence. A trade licence for asset managers requires an application to the competent trade authority. In making such an application, the AIFM has to prove that he or she employs in a management function a person that has the necessary qualifications to supervise the business operations of an asset manager (typically, a university education or practical experience, or both).

ii Ongoing obligations
Licensed AIFMs are subject to the disclosure requirements under the AIFMG, which require, inter alia, the submission of an annual report to the investors and the FMA, as well as the submission of a quarterly overview of all AIFs under management.

Under the terms of the trade licence, there are no material ongoing reporting obligations for small AIFMs (except that they have to report if a person in a management function mentioned in the application leaves the AIFM).

V OUTLOOK
2020 promises to be a relatively busy year. In the large-cap segment, one major auction has already attracted significant private equity interest and there are more in the pipeline. In the mid-cap segment, several companies are rumoured to be coming to the market in the course of the year. In terms of sectors, technology, consumer products, industrial and services, as well as real estate, are expected to be hot again. Venture capital activity is expected to increase again on the back of a very robust 2019 and an increased appetite for Austria-based start-ups from corporates and global venture capital funds.
I OVERVIEW

Deal activity

Economic growth slowed in Brazil in recent years while the country suffered a period of political instability. Because of the political and economic crisis, major projects across numerous sectors were put on hold and domestic companies faced a credit crunch. However, this scenario seems to have been changing since the new government, led by the right-wing President Jair Bolsonaro, came into power in January 2019. A positive, yet cautious, attitude has possessed investors with this change in government after more than a decade under a left-wing government marked by corruption and fraud scandals.

President Bolsonaro has gained support for his campaign promises to fight corruption, privatise state assets, reduce bureaucracy and change the public pension system. According to market analysts, the promises made by the new government have encouraged purchases in the stock market and investors are awaiting the implementation of the new government’s proposals. Although Brazil’s currency, the real, has experienced smooth appreciation in the past few years, the currency’s hefty devaluation in 2019 against the US dollar, the UK pound and the euro, and the reduction of interest rates, along with Brazil’s competitive potential and vast market, means the country remains an attractive destination for international private equity investment.

Not surprisingly, a year after the implementation of the new government, 2019 saw signs of a potential effective economic recovery, with an increase of 17 per cent in the number of mergers and acquisitions (M&A) compared with 2018. The growth was most noticeable in the areas of information technology and financial and insurance services.2

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1 Marcus Vinicius Bitencourt and Alex Jorge are partners, Renata Amorim and Marcelo Siqueira are senior associates and Ana Paula Casalatina is an associate at Campos Mello Advogados in cooperation with DLA Piper.

Another indication of the positive environment of the new government and of the economy’s recovery was a sensitive increase in the number of initial public offerings (IPOs) in 2019, to five, compared with three in 2018. In addition, according to the CEO of B3, 20 to 30 Brazilian companies could be ready to go public in 2020.

The first year of Bolsonaro’s government was also marked by the approval of important economic and legal measures, such as the social security reform and Brazilian Law No. 13,874 of 20 September 2019, also known as the Brazilian Economic Freedom Law, which has also created a positive scenario for investment in Brazil. New rules brought by the Economic Freedom Law have, among other provisions, introduced the legal grounds for the regulation of investment funds by the Brazilian Securities Commission (CVM) and have allowed:

- the creation of segregated assets for each class of shares of equity investment funds (FIPs);
- the possibility of the establishment by the FIP’s by-laws of limitation to the liability of the FIP’s shareholders to the value of their shares and also to the obligations attributable to the class of shares held by the shareholders;
- the possibility of the establishment by the FIP’s by-laws of limitation to the liability of the funds’ service providers (e.g., administrators and portfolio managers) to the obligations to be complied with by each of them (without being jointly liable), provided that the rules enacted by the CVM are also complied with; and
- the exclusion of the necessity of registration of the FIP’s by-laws with the registry of instruments and documents.

These new rules play an important role in the development of the Brazilian private equity industry by bringing internal practices closer to international practices and represent a safer, cost effective and more attractive environment for FIP investors and service providers.

According to a report prepared by the Transactional Track Record, the total aggregate value of private equity transactions in Brazil in 2019 represented an increase of more than 27 per cent compared with 2018, reaching a record value of US$6.5 billion.

2019 was also marked by the beginning of a divestment process conducted by the federal government, by means of privatisations of companies and their subsidiaries previously controlled by the federal government. This was the case in the sale of some of the power distribution companies held by Eletrobras (Companhia Energética do Piauí, Companhia Energética de Alagoas, Companhia de Eletricidade do Acre, Centrais Elétricas de Rondônia, Boa Vista Energia and Amazonas Distribuidora de Energia). Petrobras had its divestiture plan approved by means of the sale of its shares in BR Distribuidora and Refinaria

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4 B3 SA – Brasil, Bolsa, Balcão is the securities, commodities and futures exchange operating in Brazil, which resulted from the merger of BM&FBOVESPA SA Securities, Commodities and Futures Exchange with Cetip SA – Mercados Organizados in March 2017.

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as well as the sale of 90 per cent of its stake in Transportadora Associada de Gás SA (TAG), a major natural gas transmission company, to ENGIE, a French-based energy and solutions company that is the largest private power producer in Brazil, and Caisse de dépôt et placement du Québec, a Canada-based fund. These transactions were all concluded in 2019.

In this context, it is also worth mentioning that the Brazilian government is promoting the transition to an open and competitive market. This has been demonstrated by the recent enactment of Resolution No. 16/19 of the National Council for Energy Policy, which promotes principles, guidelines and recommendations for the transitioning to the ‘new gas market’. Although there are many regulatory and economic issues to tackle, specialists in the oil and gas industry are certain that the natural gas supply will grow over the next decade, accompanied by investments related to the integration of this sector with the electric and industrial sectors.

In relation to the aviation market, recent amendments to Rule No. 7,565/1986 (the Brazilian Aeronautical Code), introduced by means of Rule No. 13,842/2019, have increased the equity participation that foreign entities may hold in the capital stock of Brazilian airline companies from 20 per cent to 100 per cent. With the opening up of the aviation market, Brazil expects to see an increase in foreign investments in local airline companies, which, in turn, will represent an increase in the airline services offered in Brazil, the creation of new employment opportunities and growing competition in the airline sector.

ii Operation of the market

Brazilian practice draws a distinction between the portfolio manager and the administrator of an investment fund. The activity of both entities, regardless of the level of effort made in raising resources, is subject to the rules issued by the CVM. The operation of private equity funds is thus subject to the rules of the CVM.

Foreign private equity funds are not subject to the rules of the CVM when investing in Brazil. They are simply classified as foreign investors, and as such are subject to the general rules issued by the Central Bank on registration of capital invested in Brazil. As The Private Equity Review covers other jurisdictions, we focus here on private equity activities in which the portfolio manager is located in Brazil.

Brazilian private equity funds are subject to registration with the CVM and must have a portfolio manager, and a fiduciary administrator that must be a legal entity that is authorised to carry out all activities directly or indirectly related to the functioning and maintenance of the securities portfolio and that complies with the requirements established by CVM Instruction No. 558/15, as amended by CVM Instructions Nos. 593/17 and 597/18.10 The portfolio manager exercises the most relevant function, as it is directly responsible for managing the portfolio, including taking investment and divestment decisions. The administrator and the manager can be the same entity, as long as they comply with the requirements established by the CVM (such as, for instance, the appointment of an officer exclusively responsible for the activity of fiduciary administrator).11

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9 ibid.
10 CVM Instruction No. 558/15, as amended by CVM Instructions Nos. 593/17 and 597/18, also establishes the possibility of a legal entity that is not a financial institution to require the registration as fiduciary administrator, as long as it complies with some requirements established by the CVM.
11 CVM Instruction No. 558/15, as amended by CVM Instructions Nos. 593/17 and 597/18, has introduced new rules on the activities related to securities portfolio administration in general.
According to data published by the Brazilian Association of Financial and Capital Market Entities (ANBIMA), in November 2019, the largest private equity fund managers in Brazil in terms of assets were BB DTVM SA, Itaú Unibanco SA, Bradesco, Caixa and Banco Santander (Brasil) SA.

The CVM’s rules basically allow an administrator and manager to obtain remuneration in two formats, through administration and performance fees, to be divided between the administrator and manager as agreed between them. The administration fee is charged on a monthly basis as a percentage of the net assets. The performance fee, in turn, is only paid by the investor at the moment of redeeming an investment, as a percentage of the gain, calculated according to the criteria established at the time of registering the fund with the CVM.

In general, the manager’s remuneration is substantially higher than the administrator’s, given that the latter usually only distributes the shares and takes care of treasury matters, while the former manages the portfolio by making the investment and divestment decisions.

Average administration fees are historically around 2 per cent a year of the net assets or committed capital. In turn, the performance fees can vary considerably, but they are commonly around 20 per cent of the profit generated above a benchmark rate of return set in the fund’s by-laws. These fees are paid at the time of redeeming the investment, after adjusting for inflation.

In many cases, the fund names a representative to hold an executive position with the most important investee companies. In this situation, the person in question can receive a stock option plan or other incentive, with the cost in the final analysis passed through to the fund’s investors in proportion to the holding in the company in question.

With respect to the purchase or sale of an equity stake, the standard procedure includes the following steps:

- **a** negotiation of the terms of the deal, with the signing of a memorandum of understanding or term sheet;
- **b** the carrying out of a due diligence process by the potential buyer; tax and labour liabilities are usually the most sensitive concerns;
- **c** negotiation of the definitive documents, including the share purchase agreement and shareholders’ agreement (as the case may be);
- **d** signing;
- **e** submission to the Administrative Council for Economic Defence (CADE) if the deal is subject to antitrust notification; and
- **f** closing.

This process can vary according to the complexity of the deal and other particularities. The average time between the issue of the term sheet and the closing of the transaction is around four months if the deal is not subject to approval by CADE. The CADE rules are broad enough to cover a good number of private equity transactions and, where CADE rules apply, the acquisition documents are signed on condition that the deal can only be closed after approval by CADE.

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Another common way to sell a corporate stake when there are various interested parties is by competitive bidding. In this case, the negotiation starts with several interested parties, who analyse the preliminary data on the company and submit proposals. Those with values below the expectation of the sellers are eliminated from the running, after which only the prospective buyers with the highest valuations continue the negotiation process, until a final buyer is identified.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Private equity funds domiciled in Brazil are set up in the form of FIPs and are subject to the regulations of the CVM.14

FIPs must invest their assets in shares, subscription warrants, debentures (convertible or non-convertible into shares) and other securities convertible into or exchangeable for shares of corporations, both listed and unlisted, as well as securities that represent equity participation in limited liability companies, which is the most common company type in Brazil, especially for start-ups.

Since FIPs are subject to the regulations of the CVM, they must submit all relevant documents, such as balance sheets and portfolio composition, and report any intention to issue new fund quotas, replace the administrator or amend the by-laws, and report any pending spin-off, merger, consolidation or liquidation.

Historically, the rules on FIPs have required their active participation in the decision process of the portfolio companies, with them having effective influence in defining management strategy and policy. This is generally achieved by appointing members to the board of directors. The right of the FIP to take part in the decision-making process can also occur in one or more of the following ways: by holding shares in the controlling block; through a shareholders’ or voting agreement; or by any other agreement that ensures the fund has effective influence. The investee companies must also satisfy certain corporate governance requirements.15

Therefore, the standard investment model of the FIP is to acquire shareholding control or a relevant stake in the controlling block. Control in Brazilian law is defined as holding rights that ensure having, on a permanent basis, the majority of the votes in the decisions of the general meeting and the power to appoint the majority of the administrators (directors and officers). Participation in the controlling block is defined as being a party to a shareholders’ or voting agreement that guarantees influence in the decisions of the company.

Nevertheless, according to CVM Instruction No. 578 of 30 August 2016, FIPs are exempted from the requirement of participating in the decision-making process if the investment is reduced to less than half of the original amount invested and constitutes less

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14 CVM Instruction No. 578, mentioned below.
15 Namely, they may not issue founders’ shares or have any similar securities outstanding; they must call for a unified term of up to two years for all directors; they must disclose to the shareholders the terms of contracts with related parties, shareholders’ agreements and stock options and other similar programmes; they must pledge to resolve corporate disputes by arbitration; in the event of going public, they must give an undertaking to the fund to adhere to a trading segment of an exchange or organised over-the-counter market that requires enhanced corporate governance, in accordance with the preceding items; and their annual financial statements must be audited by an independent auditor registered with the CVM.
than 15 per cent of the company’s corporate capital; or if the book value of the investment is reduced to zero, and is approved by a shareholders’ resolution by the majority of shareholders present at the meeting, if a higher quorum is not established in the FIP’s by-laws.

Foreign private equity funds can set up a FIP in Brazil as a vehicle to make investments. As with any other foreign investment, the capital must be registered with and follow the rules of the Brazilian Central Bank.\textsuperscript{16} Income arising from investment in FIPs, and gains arising from the sale or amortisation of FIP quotas by non-resident investors that are not resident or domiciled in a favourable tax jurisdiction,\textsuperscript{17} are currently taxed at zero per cent,\textsuperscript{18} provided that the following requirements are met (the FIP Requirements):

\begin{itemize}
  \item[a] the non-resident investor\textsuperscript{19} does not hold, individually or with related parties (as defined by the applicable legislation), 40 per cent or more of all shares issued by the fund (the shareholding test)\textsuperscript{20} or does not have the right to receive 40 per cent or more of the total income generated by the fund (the economic test); the ultimate beneficial owners must be identified to the National Registry of Legal Entities in accordance with the Brazilian Federal Revenue (RFB) beneficial-owner requirement;\textsuperscript{21}
  \item[b] the fund does not have in its portfolio, at any time, debt securities in an amount exceeding 5 per cent of its net worth, unless the securities correspond to convertible debentures, subscription warrants or public bonds;
  \item[c] the fund is compliant with additional portfolio requirements provided by the CVM regulations, which currently require at least 90 per cent of the FIP portfolio to be composed of shares, subscription warrants, simple debentures or other securities convertible or exchangeable into shares issued by corporations and either closely held
\end{itemize}

\textsuperscript{16} Resolution No. 4,373 of 29 September 2014, issued by the National Monetary Council (CMN).

\textsuperscript{17} Brazilian law defines more than one concept of a favourable tax jurisdiction. However, the concept that matters for this particular analysis relates to foreign investments in the Brazilian financial and capital markets pursuant to CMN Resolution No. 4,373/14. Accordingly, the applicable concept of a favourable tax jurisdiction relates to countries that do not tax income or that tax income at a rate lower than 20 per cent, or do not provide information regarding the equity partners of legal entities, their owners or the beneficial owners of income paid to non-residents. The threshold of a standard tax rate of 20 per cent used to identify privileged tax regimes is reduced to 17 per cent if the country follows the international standards of tax transparency (Ordinance MF No. 488/14), as established by the Brazilian Federal Revenue. The Brazilian tax authorities have listed some jurisdictions as favourable tax jurisdictions. Historically, the tax authorities have viewed this list as being a \textit{numerus clausus} list; namely, any jurisdiction not appearing on the list will not be deemed a favourable tax jurisdiction. In 2017, Costa Rica, Madeira and Singapore were removed from the list.

\textsuperscript{18} Section 3 of Law No. 11,312/2006.

\textsuperscript{19} The FIP may also have Brazilian resident investors, but they will not benefit from this tax incentive.

\textsuperscript{20} The 40 per cent ceiling applies to the following parties related to individual FIP investors: (1) relatives up to the second degree, (2) companies controlled by the investor or by any of the investor's relatives up to the second degree, and (3) partners or managers of companies controlled by the investor or the investor's relatives up to the second degree. Where the investor is a legal entity, the ceiling applies to any entities that are the investor's controller, or are controlled by or affiliated to the investor.

\textsuperscript{21} Based on the literal wording of the law, one could conclude that the 40 per cent test for fulfilling the FIP Requirements is to be observed solely by the direct investors of the FIP, and not by their shareholders, partners or members (except where the shareholders, partners or members are also direct investors of the FIP), and that there is no need to account for any indirect interests. However, any analysis of the shareholding test and the economic test may be controversial, and one should consider an indirect approach and a 'substance-over-form' analysis. The rationale is to avoid using related parties (close individuals and group companies) to circumvent the ceiling of not having 40 per cent or more quotas of the FIP.
or publicly held companies, as well as securities representing equity participation in limited liability companies, provided that the FIP participates in the decision-making process of the investee companies, with effective influence on the definition of their strategic policies and management; and

d in addition to the provision mentioned in item (c), above, at least 67 per cent of the FIP’s portfolio is composed of shares of corporations, or debentures that are convertible into shares and subscription warrants (allowed assets).

Additionally, under another tax incentive regime, and provided that all quota holders are exclusively non-residents, all gains, including capital gains paid, credited, delivered or remitted to beneficiaries resident or domiciled outside Brazil (unless situated in a favourable tax jurisdiction) that are produced by investment funds are exempt from income tax if the following general cumulative requirements are met (but an analysis per asset to be invested is advisable):

a the quota holders must be exclusively non-residents; and

b the fund regulations must provide that its fund application is made exclusively in:

• assets required by tax legislation;
• cash deposits;
• assets that are also exempt from income tax, or taxed at a zero per cent rate, when the beneficiaries of the gains derived from those assets are residents or are domiciled outside Brazil (unless situated in a favourable tax jurisdiction); or
• assets traded in financial and capital markets that are exempt from taxation, provided they are negotiated by the funds under the same terms and conditions set out by law to qualify for the tax exemption.

In addition, foreign exchange transactions carried out in Brazil are subject to the tax on financial operations regarding exchange agreements (IOF) for inflow and outflow. The standard rate is currently 0.38 per cent for most foreign exchange transactions. IOF is levied at a zero per cent rate on the inflow and outflow of remittances into related investments made by non-Brazilian residents in the Brazilian financial and capital markets. There are other specific rates or exemptions that may apply to certain transactions. Although unlikely in the current economic scenario, the IOF rate, because of its regulatory rather than budgetary purpose, may be increased at any time to a maximum of 25 per cent by the government.

Notwithstanding the tax benefits listed above, the requirement to engage an administrator and manager approved by the CVM to structure a local FIP prompts most international private equity players to choose an offshore structure to invest directly in Brazil, outside the capital market. This means that the investment will be classified as a foreign direct investment, regulated by Law No. 4,131/62. A foreign direct investment can occur by incorporating a new company or investing in an existing one (a limited liability company or corporation). In some cases, the direct investment involves setting up a joint venture with a Brazilian company or other investors, and the signing of shareholders’ agreements,

22 Section 97 of Law No. 12,973/2014.
23 If the fund regulations restrict its quota holders to non-resident individuals only, the fund is also allowed to invest in assets whose gains will be exempt from individual income tax under Section 3 of Law No. 11,033/2004 (e.g., certificates of real estate receivables, and real estate investment funds).

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investment agreements or loan contracts, among other mechanisms. In addition, for foreign direct investment, both the foreign investor and the receiving company in Brazil must be registered with the Central Bank.

Recent amendments introduced by the RFB by means of Rule No. 1,634 (IN 1,634/2016), further replaced by Rule No. 1,863 (IN 1,863/2018), as amended, governing the registration of national and foreign entities with the National Registry of Legal Entities, have established the obligation for foreign shareholders of Brazilian entities, and also for Brazilian entities, to provide the RFB with information on the relevant corporate chain, including trusts and foundations, up to the individuals deemed the ultimate beneficial owners, with a few exceptions, defined as (1) the individual or individuals who either directly or indirectly own, control or significantly influence the legal entity; or (2) the individual under whose name a given transaction is performed. This obligation must be complied with during any update of any of the Brazilian or foreign entity’s RFB registry data or, in case of a new entity, up to 90 days from the date of registration before the RFB.26

There are two bills currently with the Brazilian Congress (Federal Government Bill No. 10,638/2018 and Senate Bill No. 336/2018) that may introduce substantial changes to the procedures relating to applicability of income tax due on certain financial investments and the tax treatment of certain Brazilian investments funds. Neither bill has yet been (and may not be) converted into law.

These bills aim to close a loophole that allows investors to use FIPs as if they were holding companies (property funds) for tax deferral purposes only. To try to close this tax-planning loophole, both bills focus on qualifying FIPs according to CVM regulations to establish their tax treatment.

In this sense, FIPs not qualified as investment entities but known as property funds should be taxed as legal entities and subject to corporate income tax of 34 per cent and social contributions of between zero and 9.25 per cent on gross revenues (effective taxation depends on the tax regime and the kind of revenue or gain), in which case the fund administrator is liable for the fulfilment of all tax obligations (including ancillary obligations). However, earnings accrued by such FIPs prior to 2 January 2019 will be considered as paid and subject to a 15 per cent withholding tax at the investor level.28

The rationale of these new rules seems to be to tax only the FIP in the case of property fund FIPs, and only the investor in the case of investment entity FIPs, but not both the FIP

24 IN 1,863/2018 was amended by Rules Nos. 1,895 of 27 May 2019, 1,897 of 27 June 2019 and 1,914 of 26 November 2019, and also by COCAD Declaratory Executive Act No. 2 of 30 December 2019, issued by the RFB.

25 Pursuant to IN 1,863/2016, a significant control or influence is presumed whenever the individual holds, directly or indirectly, (1) more than 25 per cent of the entity’s corporate capital, or (2) the power to control the entity’s corporate decisions and to appoint the majority of its managers.

26 IN 1,634/2016 Brazilian Federal Revenue Rule No. 1634 of 6 May 2016 initially established the deadline for the submission of information on ultimate beneficial owners as 31 December 2018. However, IN 1,863/2018 (which revoked Federal Revenue Rule No. 1634) extended the deadline to 26 June 2019 (180 days from the publication of IN 1,863/2018).

27 Corporate income tax (IRPJ/CSLL) and social contributions on gross revenues (PIS/COFINS) will be due by the FIP.

28 Sections 5, VII, 8 and 9 of Bill No. 10,638/2018.
and the investor. However, this is not so clear in the legislation (i.e., it is unclear whether property fund FIP distributions will still be considered tax-exempted dividends) and we must await changes in the bills or RFB regulations for further clarification.

However, the earnings from FIPs organised and held exclusively by non-resident investors not located in favourable tax jurisdictions and investing under National Monetary Council Resolution No. 4,373/14 in FIPs that follow the FIP Requirements would remain subject to the tax-exemption rules mentioned above, but it is unclear whether a FIP that qualifies as a property fund FIP according to CVM regulations would actually be taxed as a legal entity.

ii Fiduciary duties and liabilities

FIP administrators and managers must observe the standards of conduct established by the CVM and are liable for losses caused to investors when they act with intentional misconduct or culpability (defined as negligence, imprudence or malpractice) in violation of the law, the CVM rules or the FIP’s by-laws. The CVM has also issued specific rules for portfolio managers of funds, and any infractions subject them to penalties if they are found guilty in an administrative sanction proceeding conducted by the CVM. In this regard, it is important to mention that the recently enacted Brazilian Economic Freedom Law has set forth the possibility of establishing, in the FIP’s by-laws, limitation to the liability of the funds’ service providers (e.g., administrators and portfolio managers) to the obligations to be complied with by each of them (without being jointly liable), provided that the rules enacted by the CVM are also complied with. Likewise, pursuant to the new provisions of the Brazilian Economic Freedom Law, it is now also possible to establish, in the FIP’s by-laws, limitation to the liability of the FIP’s shareholders to the value of their shares.

As a complement to the CVM rules, the Brazilian Private Equity and Venture Capital Association (ABVCAP) and ANBIMA have issued their Regulation and Best Practices Code for the FIP market with the aim of raising fiduciary standards and promoting best practices, and to allow the gradual integration of the Brazilian investment fund market with the international private equity market. Adherence to this Code is mandatory for those members of ABVCAP and ANBIMA engaging in administration and portfolio management activities.

Representatives of the manager named as directors, officers or other executive positions in the investee companies also have the duties to the company required of administrators in general by the Law of Corporations. Accordingly, they must employ, in the exercise of their functions, the same care and diligence employed by all active and honest people in handling their own affairs, following the law and the company by-laws; they must always act in the company's best interests; and they must satisfy the greater public good and the social function of the company.

The fund administrators or managers must also observe the duties attributed by the Law of Corporations to shareholders. Accordingly, they must exercise the right to vote in general meetings in the interest of the company and can be held liable for any damages arising from the exercise of this voting right.

29 Section 5, IV of Bill No. 10.638/2018.
30 CVM Instruction No. 558/15, as amended by CVM Instructions Nos. 593/17 and 597/18, has introduced new rules on the activities related to securities portfolio administration in general.
31 ABVCAP–ANBIMA's Regulation and Best Practices Code: Private Equity and Venture Capital Funds.
III YEAR IN REVIEW

i Recent deal activity

Despite 2018’s economic and political instability, 2019 marked the recovery of the Brazilian economy with important deals being carried out.

In this context, the Brazilian healthcare market has sustained great investment levels and an astounding record of 80 M&A deals in 2019, which is almost double the quantity of the previous year. In addition to the M&A deals, there is a verticalisation process in progress in the healthcare market: healthcare operators are building their own hospital network. Many of the highest-valued transactions of 2019 were backed by private equity funds, as was the case in the sale of São Francisco Saúde Group (which had a private equity fund managed by Gavea Investimentos as one of its shareholders) to Hapvida, one of Brazil’s largest healthcare operators, for over US$1.2 billion. Similarly, in early 2020, Rede D’or São Luiz SA, one of Brazil’s largest hospital groups, concluded all the transactions it announced in 2019 (i.e., the acquisition of 100 per cent of the quotas issued by Casa de Saúde Laranjeiras Ltda (which was the owner of a maternity unit network called Perinatal), Unidade Neonatal da Lagoa Ltda and Cia de Serviços Especiais e Unificados Ltda, strengthening its portfolio in Rio de Janeiro. Rede D’or also acquired 100 per cent of the shares issued by Hospital Santa Cruz (operator of the healthcare plan Paraná Clínicas).

Furthermore, one of the restructuring transactions that the market is eagerly anticipating is the joint-venture deal of the Boeing Company, the world’s largest aerospace company, and Embraer SA, the Brazilian business conglomerate that manufactures commercial and military aircraft (which is one of Brazil's leading exporters). This partnership was valued at US$4.2 billion and contemplates the constitution of (1) a commercial aviation joint venture, in which Boeing will hold 80 per cent of the shares and Embraer will hold the remaining equity participation of 20 per cent, and (2) a KC-390 joint venture, in which Boeing will hold 49 per cent of the equity participation and Embraer will hold the remaining 51 per cent. Although negotiations began in 2018, there are still some steps pending to be complied with before the closing of the transaction. While Embraer’s board of directors, shareholders’ and CADE approved the deal, the analysis is still in progress before the European Commission, which has opened an in-depth investigation into competition issues.

Another example of the Brazilian market recovery in 2019 was the increase in the number of Brazilian companies, including Loggi, Gympass, QuintoAndar, Ebanx and Wildlife Studios, that were added to the list of global ‘unicorns’ (start-ups valued at over...
US$1 billion). At the very beginning of 2020, another Brazilian start-up company, Loft, which focuses on the acquisition of real estate for refurbishment and subsequent sale, was also consolidated as a unicorn, after a new round of investment led by US funds Vulcan Capital and Andreessen Horowitz, in the amount of, approximately, US$175 million.

In addition, the practice of corporate venture capital (CVC), which is the investment by well-established institutions in early stage companies (that are outside the investing company’s corporate chain), is also progressively gaining strength in Brazil. The main purpose of CVC investment is for the well-established company to develop a new product or specific market upon investment in an early stage company, rather than by setting up an internal research and development (R&D) department, as the R&D route may prove to be more costly, time-consuming and demanding than investing in an early stage company. CVC goes beyond a customary M&A transaction, although the process and the documentation involved may be similar. In CVC transactions, the investing company and the target company establish certain common goals so that the investment may be successful. The investing company may also provide the target company with management and marketing expertise, strategic direction or a line of credit, or a combination of these.

Many Brazilian companies have embraced CVC investment for innovation purposes, including Embraer SA (the Brazilian business conglomerate that manufactures commercial and military aircraft, among other things), banks Banco de Brasil, Banco BMG, Itaú and Santander, manufacturers Gerdau, Votorantim and Natura (a cosmetics manufacturer), and retailers Pão de Açúcar and Magazine Luiza.

ii Financing

The scenario for financing of private equity changed substantially in 2016 with the issuance of CVM Instruction No. 578, which aimed to unify and modernise the rules on incorporation, operation and management of FIPs, and also consolidated previous amendments to the provisions on the structure of, and guidelines for, FIPs.

The main changes introduced by CVM Instruction No. 578 include FIPs now being able to:

a invest in limited liability companies and in non-convertible debentures;  
b invest up to 20 per cent of their net equity in offshore private equity assets, as long as the foreign assets have the same economic nature of the assets that may be part of a FIP’s portfolio in Brazil; and  
c have authorised capital, which means that the administrator may issue new quotas in FIPs without requiring investors’ reapproval.

CVM Instruction No. 578 also created different categories of FIPs, such as the Seed Capital FIP, which allows the use of a FIP, under certain conditions, as a vehicle to invest in start-up

40 Although CVM Instruction No. 578 was enacted in August 2016, the FIPs had until August 2017 to adopt the new rules.  
41 Previously, according to CVM Instruction No. 391, FIPs could only invest in corporations and not in limited liability companies. Additionally, FIPs could not invest in non-convertible debentures, only in convertible ones.
companies. Furthermore, the administrator may create different classes of shares, which may have different rights, permitting differentiation as to, among other things, hurdle rates; management fees and performance fees; the timing of capital calls, amortisation and redemption; and veto rights and the appointment of committee members. According to the recently enacted Brazilian Economic Freedom Law, it is now also possible to create segregated assets for each class of shares of the FIP.

To harmonise Brazilian accounting principles with international standards, FIPs qualified as investment entities must mark portfolio assets according to their fair value, while FIPs that do not qualify as investment entities must register their investments in accordance with the rules applicable to affiliates of publicly traded companies, and are now required to prepare and submit audited financial statements whenever there is a material change in the fair value of the investment company during the fiscal year. In this regard, CVM Instruction No. 579 was issued on 30 August 2016, creating new rules for the provision of financial statements of FIPs, outlining the accounting methods for the classification of assets and liabilities.

iii Key terms of recent control transactions

Acquisitions of control are characterised by the signing of documents that protect the purchaser from possible liabilities not reflected on the balance sheet at the time of closing, including instruments to adjust the price, escrow accounts and similar arrangements. Additionally, with the alteration of the rule for prior submission of transactions involving a change in control to CADE, the moment of closing now occurs in some cases several months after execution of the binding documents. This makes it more necessary than ever to include protective clauses covering price adjustment and material adverse change.

Where a particular shareholder has great importance in the development of the company’s business plan, a lock-up clause can be used, preventing this shareholder from selling the relevant shares during a certain period, to assure that the transition to management by the new controllers will proceed as smoothly as possible.

In transactions involving listed corporations, the transfer of control can only be contracted under the condition that the purchaser launches a public tender offer to acquire the shares of the other owners.43

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42 CVM Instruction No. 579 applies to accounting periods initiated on or after 1 January 2017.
43 Article 254-A of the Law of Corporations determines that the buyer must launch a public tender offer to acquire the voting shares owned by the other shareholders at a price per share of at least 80 per cent of that paid for the shares in the controlling block. In the case of companies listed in the Novo Mercado and Level 2 trading segments of BM&FBOVESPA (the top two enhanced governance segments), the public offer must target all the remaining shares, for the same price paid to those of the controlling block, to assure equal treatment between minority and controlling shareholders.
iv Exits

2018 saw divestments in the amount of, approximately, US$3.39 billion. The data for 2019 are not available at the time of writing; however, experts expect an upward trend in this period.

Divestment by way of an IPO is a typical exit strategy in the Brazilian market. One example is the investment made in 2012 by FIP Carlyle Group to acquire 85 per cent of the stock issued by Ri Happy, Brazil’s largest toy retailer. In 2018, Carlyle Group demonstrated its intention to launch the IPO of the company and use the funds raised to open new stores. However, the IPO that was scheduled for 2018 was postponed because of low demand from investors.

2019 was also marked by the beginning of a divestment process conducted by the federal government, by means of divestments and privatisations of companies and their subsidiaries previously controlled by the federal government. The total amount of such transactions in 2019 was equivalent to, approximately, US$24.9 billion, from which:

a) US$12.65 billion related to privatisations (including, among other transactions, the sale of TAG and BR Distribuidora);

b) US$9 billion related to divestitures, such as the sale of the majority of the federal government’s shares in the reinsurer IRB Brasil Resseguros and the sale, by means of an IPO, of the shares held by the state-controlled bank Banco do Brasil SA in the Brazilian power utility company Neoenergia SA; and

c) approximately US$3.27 billion related to the sale of oil fields by Petrobras.

In addition to these transactions, another important transaction in the oil and gas sector was the investment of a private equity fund managed by Starboard Asset in the oil company 3R Petroleum, aiming for the acquisition of an onshore oil field from Petrobras in the amount of approximately US$191.1 million. Upon the fulfilment of certain conditions precedent, the acquisition will mark the first time a private equity fund will take over the operation of an onshore oil field.

IV REGULATORY DEVELOPMENTS

Private equity deals can be carried out by means of offshore structures, with capital raising and legal structuring done outside the country, resulting in a foreign direct investment from the standpoint of the Central Bank; or through transactions carried out by funds domiciled in Brazil, subject to the rules of the CVM.

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44 These monetary values have been converted from Brazilian reais to US dollars at the exchange rate on 31 December 2019, as published by the Brazilian Central Bank. See ‘Consolidação de Dados 2019: Indústria de Private Equity e Venture Capital no Brasil’, KPMG and ABVCAP.


46 These monetary values have been converted from Brazilian reais to US dollars at the exchange rate for 31 December 2019, as published by the Brazilian Central Bank.

As well as issuing rules on the capital market and investment fund industry, the CVM oversees the activities of players and enforces rules through investigations and administrative proceedings. Punishments for wrongdoing range from a formal warning to the application of fines and even a prohibition on operating in the capital market.

In addition, many sectors of the Brazilian economy are subject to the specific oversight of regulatory agencies, some of which regulate M&A transactions, enforce technical, legal and financial requirements to be observed by the parties involved, and have to be consulted before changes of control are concluded. This means, in effect, that their approval must be obtained before closing a deal and, where this is the case, both the regulatory agency and CADE have the power to block transactions.

V OUTLOOK

Companies, financial institutions and investors are waiting for the continued implementation of the proposals submitted by the new Brazilian government, which aim to rebalance the public accounts and, consequently, attract new investment.

Moreover, the private equity industry in Brazil has been growing strongly in the past couple of decades, and there is great demand for investment in various sectors; in particular, in Brazil’s infrastructure and in oil and gas, given the potential for privatisation of state-owned companies.

The private equity investment environment has also been continuously modernising and adjusting to the environment of international markets. Other measures to expand the private equity market are being put in place, such as specific rules for investments in special segments or in organised over-the-counter markets.

Although the right-wing administration of the new government elected in 2019 has shown a tendency for flexibility in, and relaxation of, certain rules applicable to the private equity industry in Brazil, by means of the approval of important economic and legal measures, such as the Brazilian Economic Freedom Law, there are still major challenges to be overcome before investments can be made in the country, such as the complex and burdensome tax system and the high level of regulation of the economy. It is, therefore, necessary to retain the advice of specialist advisers before investing in Brazil.
Chapter 4

CHINA

Xiaoxi Lin, Han Gao and Rongjing Zhao

I OVERVIEW

With increasing political and economic uncertainties in China and the rest of the world in 2019 (including the US–China trade war), private equity activity in China became subdued. In 2019, private equity investments in China decreased substantially in terms of both volume and value, hitting the lowest levels of any period over the past five years. According to AVCJ Research, the market research division of Asian Venture Capital Journal, there were 1,824 private equity investments (of which 729 were publicly disclosed) with an aggregate investment amount of US$60.436 billion in China in 2019.\(^2\) Compared with 1,970 investments with an aggregate amount invested of US$95.288 billion in 2018, the total volume of investments decreased by 7.4 per cent and the total value decreased by 36.6 per cent in 2019. In 2019, private equity investments in China accounted for 36 per cent of the total value of private equity investments in the Asia-Pacific region, which is the first time this proportion has fallen below 40 per cent in the past five years.

The distribution among different investment types in 2019, compared with that in 2018, exhibited an increase in expansion and growth-stage investments, a substantial decline in mezzanine and pre-initial public offering (IPO) stage investments, and a slight drop in start-up and early stage investments, along with a decline in buyout investments (including management buyout, management buy-in, leverage buyout and turnaround or restructuring stages). According to AVCJ Research, investments at expansion and growth stages stayed ahead of other investment stages, at US$48.270 billion or 79.9 per cent of total investment value in 2019, up from 57.7 per cent in 2018; investments at mezzanine and pre-IPO stages dropped from US$19.372 billion or 20.3 per cent of total investment value in 2018 to US$1.195 billion or 2 per cent of total investment value in 2019; investments in the start-up and early stages represented a smaller proportion of total investment value in 2019 than in 2018, dropping from US$11.769 billion or 12.4 per cent of total investment value in 2018 to US$4.837 billion or 8 per cent of total investment value in 2019; and buyout transactions declined from US$5.048 billion or 5.3 per cent of total investment value in 2018 to US$2.195 billion or 3.6 per cent of total investment value in 2019.

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1 Xiaoxi Lin, Han Gao and Rongjing Zhao are partners at Kirkland & Ellis International LLP. The authors wish to give special thanks to Jiayi Wang, Zhiyuan Gu and Ariel Chen for their significant contributions to this chapter, and to other Kirkland & Ellis Asia colleagues, Pierre Arsenault, Daniel Dusek, David Patrick Eich, Chuan Li, Gary Li, Jesse Sheley, Chelsea Xuan, David Zhang, Tiana Zhang and Jodi Wu, for contributing to this chapter.

2 As at 22 January 2020.
The continuing decline in private equity buyouts in 2019 was particularly noteworthy given the overall trend in that space since 2010. While traditionally buyouts in China have remained relatively less frequent in comparison with many other jurisdictions, buyout activities experienced an increase in 2010 and 2011, further strengthened in 2012 to 2014 amid growing popularity of going-private transactions involving China-based companies, particularly companies listed in the United States, and boomed to be the bandwagon in 2015 as many US-listed Chinese companies received going-private proposals at the prospect of seeking a future listing on China's A-share market or the Hong Kong Stock Exchange. After experiencing a decline in 2016 and a short recovery in 2017, buyout activities in China hit a record low in 2018 and further dropped to the lowest point in history in 2019, and going-private activities were almost suspended. Based on statistics obtained through searches on the Thomson Reuters database Thomson ONE, of the 213 going-private transactions announced since 2010, 15 did not proceed and 142 have closed (12 closed in 2010, 17 in 2011, 24 in 2012, 26 in 2013, six in 2014, 27 in 2015, 17 in 2016, eight in 2017, two in 2018 and three in 2019). As at 31 December 2019, 24 going-private transactions were pending, including two announced in 2012, one announced in 2013, two announced in 2014, three announced in 2015, three announced in 2016, four announced in 2017, three announced in 2018 and six announced in 2019.

In respect of exits via IPOs, China undertook a moratorium on A-share IPOs from November 2012 to December 2013, and imposed another four-month moratorium on A-share IPOs in 2015. Following a strong recovery with a record number of successful IPOs in the Chinese domestic IPO market in 2016 and early 2017, the number of Chinese domestic IPOs dropped significantly at the end of 2017 until the second half of 2018 on account of tightened review standards, and a large number of IPO applications were queued. In part as a result of this large backlog, private equity-backed IPOs, an exit route heavily relied upon by China-focused private equity funds, experienced a dramatic decline in 2018, from 282 in 2017 to 93 in 2018, according to AVCJ Research. In 2019, China inaugurated its science and technology innovation board (Sci-tech Innovation Board), trying to kick off the country's much-anticipated capital market reform. To address private equity investors' concern on the potential backlog to list on the Sci-tech Innovation Board, China tried to implement a registration-based IPO regime on this new Board. With the newly launched Board, 202 Chinese enterprises accomplished A-share IPOs successfully in 2019 (including 70 companies that were successfully listed on the Sci-tech Innovation Board), which hits the highest watermark over the past five years. With that said, the number of private equity-backed IPOs decreased to 80 in 2019. The effect of the Sci-tech Innovation Board and the relevant policies thereof for private equity investors and their investments strategies in China are yet to be tested. Exits via trade sales and secondary sales, accounting for 84.3 and 10.1 per cent, respectively, of private equity-backed exits in 2018, and 91.7 and 6.3 per cent, respectively, in 2019, remained the dominant exit route for private equity funds in 2019 and are likely to maintain this position in the foreseeable future.

In 2019, Chinese outbound M&A deal activity declined to a low point from the record-hitting level seen in 2016. This was partially because of political and economic uncertainties within China and the rest of the world in 2019 (including the US–China trade war), heightened scrutiny over these transactions by the United States and certain European

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3 AVCJ Research.
4 ibid.
countries, and also because Chinese regulators have promulgated guidelines and policies on foreign exchange outflow control, and on the outbound target industries and channels for onshore financing affecting outbound investment activities, and have encouraged a more strategic and prudent approach in Chinese outbound investments. According to Thomson Reuters and PricewaterhouseCoopers analysis, in the first half of 2019, financial investor-backed Chinese outbound investments generally maintained the level of activity seen in the first half of 2018 in terms of the number of announced deals, with 134 deals announced in the first half of 2019 and 139 announced in the first half of 2018, while the announced deal value in the first half of 2019 declined by 48 per cent compared with the deal value in the first half of 2018. In addition, state-owned enterprise-backed Chinese outbound investments (which were historically the mainstream of the outbound investments in 2016) in 2019 decreased to the lowest point of any period over the past 10 years in terms of the value of announced deals.

II REGULATORY FRAMEWORK

Investments through acquisition of control and minority interests

China's current Companies Law, which became effective on 1 January 2006 and was amended in 2013 and 2018 with effect from 26 October 2018, sets out the governance framework for the two types of Chinese companies: companies limited by shares and limited liability companies. A Chinese entity in which a non-Chinese investor owns an equity interest is called a foreign-invested enterprise (FIE), of which there are several types, including a wholly foreign-owned enterprise (WFOE), an equity or cooperative joint venture (EJV and CJV, respectively) and a foreign-invested company limited by shares.

To grant FIEs the same treatment in terms of corporate registration and other administrative procedures as Chinese domestic companies (to the extent possible and except where the principal business of the FIE falls within the scope of the Foreign Investment Negative List), China abolished a series of laws and regulations that had governed FIEs in the past and further adopted a completely new regime in favour of non-Chinese investors in 2019. Since 1 January 2020, FIEs have been subject to the Companies Law, the Foreign Investment Law (FIL), which was promulgated on 15 March 2019 and became effective on 1 January 2020, and the Regulation on the Implementation of the Foreign Investment Law (the FIL Implementation Regulation), which was promulgated on 26 December 2019 and became effective on 1 January 2020. The Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the M&A Rules), jointly issued by six governmental agencies in 2006 and amended in 2009, establish a general legal framework under which non-Chinese investors can acquire the equity or assets of Chinese companies subject to regulatory approvals. However, through a series of amendments to various regulations between 2016 and 2019, the regulatory approvals established by the M&A Rules are, in practice, no longer required; instead there is a notification regime in place for FIEs. This notification regime took effect on the same date as the FIL and the FIL Implementation Regulation became effective (i.e., 1 January 2020) and shall be applied with respect to the incorporation, dissolution and change of corporate registration information of FIEs, as well as the general mergers and acquisitions made by foreign investors in a Chinese entity, provided that the transaction does not trigger ‘special management measures for foreign investment access’ under the Special Administrative Measures (Negative List) for the Access of Foreign Investment (the Foreign Investment Negative List) (as discussed below). In practice, the
notification regime is integrated as part of the regular online registration procedure with the State Administration of Market Regulation (SAMR, the company registry agency that records all corporate registration information of legal entities incorporated under Chinese laws, whether domestic companies or FIEs). See Section IV for a detailed introduction of the FIL and the FIL Implementation Regulation.

**Regulatory regimes applicable to foreign investments**

An acquisition of or investment in a Chinese entity by a non-Chinese investor is subject to a multilayered government approval, information-reporting filing and registration process. Subject to the recent developments in respect of the information-reporting regime applicable to FIEs (see Section IV.i), the highest level of scrutiny is applicable to onshore investments (that is, direct acquisitions of equity in Chinese companies by a non-Chinese investor), which require the applicable project-based approval of the National Development and Reform Commission (NDRC) or its local counterpart, and the approval by, or information reporting to, central Ministry of Commerce (MOFCOM) if the size of a greenfield investment or the total investment amount of a target company whose business is in the industries specified in the Foreign Investment Negative List (as discussed below) exceeds US$1 billion, or MOFCOM’s local counterpart if the size of the investment falls below US$1 billion but the target’s business still falls within the industries specified in the Foreign Investment Negative List. Approval at the local level can typically be obtained within one month, but approval from central MOFCOM and NDRC often takes several months or longer. If a transaction is subject to an antitrust or national security review, as discussed below, MOFCOM or its local counterpart will typically defer review until the antitrust or national security reviews are completed.

Whether MOFCOM and NDRC will grant approval for a restricted transaction depends in part on whether the type of the underlying acquisition target falls within the scope of the Foreign Investment Negative List, jointly published annually by MOFCOM and NDRC (with the latest edition published on 30 June 2019 and effective from 30 July 2019), which lists the industries where special management measures for foreign investment access are applicable. The Foreign Investment Negative List partially replaces the former Catalogue for the Guidance of Foreign Investment Industries (the Foreign Investment Catalogue), and instead of grouping industries for foreign investment into ‘encouraged’, ‘prohibited’ and ‘restricted’ categories as the Foreign Investment Catalogue did, the Foreign Investment Negative List specifies only two categories of industries: industries in which foreign investment is prohibited and industries in which foreign investment is allowed with certain investment restrictions. Industries not mentioned by the Foreign Investment Negative List are deemed ‘permitted’ (i.e., not subject to the special management measures for foreign investment access). On 30 June 2019, NDRC and MOFCOM promulgated the Catalogue of Encouraged Industries for Foreign Investment (2019) (the Catalogue of Encouraged Industries), which became effective on 30 July 2019. The Catalogue of Encouraged Industries consists of two sub-catalogues (the list applicable to the entire country and the list applicable to China’s central, western and north-eastern regions and Hainan province only). With the effectiveness of the Catalogue of Encouraged Industries and the latest Foreign Investment Negative List, the Foreign Investment Catalogue is now officially and entirely repealed. While a non-Chinese investor can acquire full ownership of a company in most encouraged and permitted sectors (and is often entitled to special advantages compared to domestic investors when acquiring a company in an encouraged sector), to invest in most sectors subject to the special management measures for foreign investment access (i.e., restricted industries), a
non-Chinese investor is required to team up with a Chinese partner (and, in some cases, the Chinese partner must maintain a controlling stake). Investments by a non-Chinese party in a prohibited sector are typically prohibited.

In addition to these general approval requirements, foreign investments in several industries, such as construction and telecommunications, are subject to approval from the relevant Chinese regulatory authorities governing the applicable industries.

An indirect investment in China by way of an offshore investment in an offshore holding company that owns equity of an FIE is not subject to MOFCOM and NDRC approvals applicable to an onshore investment; however, both an onshore and an offshore investment may be subject to China’s antitrust and national security review schemes.

The antitrust regime in China is established and governed by the Anti-Monopoly Law of the People’s Republic of China (AML), which became effective on 1 August 2008. Under the AML, an antitrust filing with the SAMR anti-monopoly authority is required for any transaction involving a change of control if the sales in China in the prior accounting year of each of at least two of the parties involved exceeded 400 million yuan, and all of the parties’ aggregate worldwide sales in the prior accounting year exceeded 10 billion yuan or the parties’ aggregate sales in China in the prior accounting year exceeded 2 billion yuan. These monetary thresholds will remain unchanged until new ones are promulgated in an amendment to the AML; to date, there has been no amendment to these thresholds since 2008.

On 1 July 2019, SAMR published three new anti-monopoly regulations (the Interim Provisions on the Prohibition of Monopoly Agreements, the Interim Provisions on the Prohibition of the Abuse of Market Dominant Status and the Interim Provisions on Prevention of the Abuse of Administrative Power to Exclude or Restrict Competition as the guideline on enforcement of the AML). These three regulations became effective on 1 September 2019. On 1 January 2020, SAMR further released a draft of the amendment to the Anti-Monopoly Law (the Draft AML) for public comment. The Draft AML imposes harsher penalties on monopolistic conduct and proposes to increase the maximum fine for monopolistic agreements from 500,000 yuan to 50 million yuan. The Draft AML also introduces criminal liabilities for individuals engaged in monopolistic conduct for the first time. The definition and scope of monopolistic agreements have been expanded to include ‘hub-and-spoke’ arrangements. In addition, SAMR will have greater flexibility in merger reviews by tolling the statutory timeline, reaching a wider range of deals and revoking previous decisions on the basis of false or inaccurate information under the Draft AML. The Draft AML will be subject to various rounds of review and comments before it can be officially adopted and may be further revised during the review process; it is, therefore, unclear whether and when the above changes will become binding law.

In February 2011, China’s State Council issued Circular 6, which established a national security review scheme for the acquisition of a Chinese business by one or more non-Chinese investors. Two broad transaction types are subject to Circular 6 review:

a) the ‘acquisition’ of any stake (regardless of the size) in a military enterprise, a supplier to a military enterprise, a company located near sensitive military facilities or any other company relating to national defence; and

b) the acquisition involving ‘control’ of a Chinese company whose business involves ‘key’ agricultural products, energy and resources, infrastructure, transportation services or technologies or manufacturing of equipment and machinery ‘affecting national security’.
In April 2015, the General Office of the State Council issued the Tentative Measures for the National Security Review of Foreign Investment in Pilot Free Trade Zones, which took effect in May 2015 (the Tentative Measures). Under the Tentative Measures, the national security review extends to foreign investment in important culture and information technology products sectors that are vital to national security and in which foreign investors have de facto control over the invested entities. The types of foreign investments regulated by these Tentative Measures include sole proprietorship, joint venture, equity or asset acquisition, control by contractual arrangements, nominal holding of interests, trust, re-investment, offshore transactions, leasehold and subscription of convertible bonds.

Both China’s antitrust and national security review schemes provide Chinese authorities with wide discretion to determine whether a transaction is subject to review and, if subject to review, whether it should be blocked. Under Circular 6, the meanings of ‘key’ and ‘affecting national security’ are undefined. Provisions issued by MOFCOM in 2011 to implement Circular 6 prohibit an investor from circumventing the national security review by structuring a transaction by way of nominee arrangement, trust, multilayered re-investment, lease, loan, contractual control, offshore transaction or other such structuring. Under both the AML and Circular 6 and other regulations regarding antitrust or national security review, control is defined broadly and includes having voting rights sufficient to exercise a major impact on board or shareholder resolutions, particularly with respect to key business or operational decisions. As such, private equity investments involving certain customary protections (e.g., veto rights, supermajority voting requirements and negative covenants) could arguably be interpreted to involve control under both statutes. If there is ambiguity as to whether a filing is required, it is usually prudent for an investor to make a filing to avoid adverse consequences later. After SAMR was established and assumed responsibility for antitrust filing matters, the State Council issued revised guidelines on antitrust filings in September 2018, which are not substantially different from the original guidelines and have simply changed the relevant regulatory authority’s name and where the relevant party should submit the filing. Prior to this 2018 version, the 2014 revised guidelines attempted to clarify the moderately controversial concept of control in the context of antitrust filings and provided for a formal pre-filing consultation with the Anti-Monopoly Bureau of MOFCOM (changed to the Anti-Monopoly Bureau of the State Administration of Market Regulation in the 2018 guidelines) for investors, to assist them in determining whether a filing would be triggered. If a transaction is subject to national security or antitrust review, the anti-monopoly authority will conduct a policy-driven review to determine whether the transaction can proceed unimpededly: it considers not only the effect of a transaction on national security or competition, as applicable, but also takes into account its effect on public interest and the stability of the national economy and social order, as well as the views of industry associations and other market participants.

In addition, the FIL has set out the principle that the Chinese government shall establish a national security review of foreign investment without specifying the details. Accordingly, the Chinese government may also create separate legislation on a foreign investment’s national security review to better protect its own national interest.

Further, the M&A Rules contain, in effect, a restriction on ‘round-trip’ investments by requiring MOFCOM approval for any acquisition of a Chinese company by an offshore company formed or controlled by any Chinese entity or individual affiliated with the Chinese target company. Typically, this approval is not granted. Where the offshore structure was in place prior to the adoption of the M&A Rules in 2006, however, the acquisition of a Chinese target by the offshore entity may still be permitted.
Governance of and exit from onshore joint ventures
Since the FIL became effective, all FIEs are regulated pursuant to the Companies Law, the FIL and the FIL Implementation Regulation, which enables foreign shareholders in an FIE to more easily obtain or enforce certain contractual rights that are considered fundamental for private equity investors in other jurisdictions, including rights pertaining to governance and exit, compared with the old regulatory framework that applied to FIEs before the adoption of the FIL, as some previous onerous requirements on corporate governance of FIEs have been abolished (e.g., for Chinese–foreign EJVs, certain key corporate actions required unanimous approval by the board; a Chinese partner typically had the right to appoint at least one director, which basically gave the Chinese partner certain veto rights regardless of its shareholding percentage).

If the Chinese shareholder is a state-owned enterprise (SOE), enforcement may be a bit difficult, as a transfer of an SOE’s interest in a joint venture is subject to a statutory appraisal and an open bidding procedure, unless waived by the appropriate authorities. Regardless of what rights may be contained in a joint venture contract, a local Chinese court injunction granting specific performance against a Chinese shareholder and in favour of a foreign investor is far from certain.

Implications of the regulatory framework on a transaction structure
To avoid the requirements of obtaining NDRC and MOFCOM approval and to enhance structuring flexibility, foreign private equity investors typically prefer to invest in China through an offshore investment. The ideal transaction structure, when feasible, is that the foreign investor invests alongside a Chinese partner in an offshore Cayman Islands or British Virgin Islands company, with the company owning 100 per cent of a Chinese WFOE (often indirectly through a Hong Kong entity, to obtain preferential treatment on dividends). This structure also allows the foreign investor to benefit from transaction agreements governed by foreign laws and to avoid the need to enforce its rights in China. Because of foreign ownership limitations and the prohibition on round-trip investments, however, this offshore structure is seldom available for foreign investments in Chinese targets that have not formed an offshore holding structure prior to the effectiveness of the M&A Rules.

Many non-Chinese investors use a ‘variable interest entity’ (VIE) structure to invest (indirectly) in China to avoid seeking certain Chinese regulatory approvals (approvals that will not or will not be expected to be granted to FIEs). Under a VIE structure, Chinese individuals, often the founders, key management members or their relatives, are the registered shareholders of a domestic operating company, which holds the required licences and permits needed for the business to operate. An investor (often in conjunction with the founders) then forms a WFOE through an offshore entity it owns, and the WFOE enters into a series of contractual arrangements with the operating company and its registered shareholders pursuant to which the WFOE obtains control and an economic interest in the operating company. These contractual arrangements can take many forms, but often include an exclusive service or licence agreement, a voting proxy agreement, a share pledge agreement and a loan agreement, and an exclusive option agreement (together with a form of equity transfer agreement) allowing the WFOE (when permitted by Chinese law) or its appropriate affiliates or designees to acquire the equity interests or assets of the operating company. Commentators frequently note that the VIE structure is legally risky given that it arguably violates the spirit (if not the explicit text) of Chinese regulations; however, Chinese companies, including some of the large public companies, such as Alibaba, Baidu and Tencent, continue to use this structure.

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The FIL and the FIL Implementation Regulation chose to remain silent on the topic of VIE. It is understandable that, given the large number of enterprises currently adopting the VIE structure, the potential impact of changing the status quo may be significant and unpredictable. Notably, the FIL provides that foreign investment includes the circumstance where a foreign investor acquires shares, equities, property shares or any other ‘similar rights and interests’ of an enterprise within the territory of China. ‘Similar rights’ is a term broad enough to include interests derived from a VIE structure. It not only affords companies enough room to manoeuvre but also gives the government ground to assert jurisdiction over the VIE structure when the time is right. Given the continuous reform in and opening up of China and the decrease in foreign investment restrictions, it will come as no surprise if the Chinese government decides to deal with VIE structures in the future when such issue is ripe for resolution.

ii  Fiduciary duties and liability

**Fiduciary duties and potential liabilities of directors, officers and supervisors under Chinese law**

The Companies Law is the primary statute regulating the actions and duties of directors, officers and supervisors of a Chinese company. Pursuant to the Companies Law, a director, officer or supervisor must abide by the laws, administrative regulations and articles of association of the company, and has duties of loyalty and care to the company. Similar to many other countries, a breach of duty by a director, officer or supervisor of a Chinese company may give rise to civil, administrative or criminal liability. A particular concern to a private equity investor in China, however, is that a director, officer or supervisor may be liable for criminal liability not only for his or her own wrongdoing, but also for crimes committed by the company if he or she is the ‘manager directly in charge’ or ‘person directly responsible’ for the management of the matter with respect to which a specific criminal act was committed by the company. This risk of personal liability for company wrongdoing is more acute for a director or officer who is also the chairperson of the board, executive director or legal representative of the company or who otherwise serves in a senior management capacity, such as a general manager or chief financial officer. Often by way of seeking to ensure that their representatives are not assigned responsibility for any specific matters, most non-Chinese private equity funds are comfortable appointing their representatives to the boards of Chinese companies, despite the risk of liability. While directors’ and officers’ insurance and indemnification agreements may protect against civil liability, many types of administrative or criminal liability cannot be mitigated by insurance and indemnification.

**Chinese tax exposure**

Since January 2008, China’s Enterprise Income Tax Law (the EIT Law) has imposed a 10 per cent capital gains tax on the sale of a domestic Chinese company by a foreign investor. On 3 February 2015, the State Administration of Taxation of the People’s Republic of China (PRC) issued Circular (2015) No. 7 (Circular 7) on Chinese corporate income tax treatments of indirect transfers of Chinese assets (including equity interest in a Chinese company) by non-resident enterprises. Under Circular 7, an indirect equity transfer of a Chinese entity by an offshore seller (such as selling the equity of an offshore holding company) that does not have a reasonable commercial purpose and that is structured to avoid applicable Chinese taxes will be re-characterised by the Chinese tax authorities as a direct equity transfer of the Chinese entity for Chinese tax purposes, and the offshore seller will be required to pay
capital gains tax for the transaction. Although it is within the discretion of the parties to such offshore transactions to determine whether to make a Circular 7 filing to report the offshore transaction for the Chinese tax authorities’ assessment for Chinese tax purposes, Circular 7 employs a penalty structure designed to motivate parties to offshore transactions involving indirect sales of Chinese companies to report potentially taxable transactions to the Chinese tax authorities. Because of the uncertainty under the Circular 7 regime regarding what will satisfy the Chinese tax authorities as a non-tax-avoidance justification with reasonable commercial purpose for the offshore sale of Chinese entities, and regarding the evolving market practice with respect to these matters, many practitioners interpret the application of Circular 7 in a broad way and recommend making Circular 7 filings to reduce the risks and potential penalties for evading Chinese tax obligations.

An offshore vehicle established by a non-Chinese private equity investor to make an investment in a Chinese company will be treated as a ‘PRC-resident enterprise’ under the EIT Law, and will be subject to a flat 25 per cent enterprise income tax on its worldwide income if the offshore vehicle’s de facto management body is in China. Although the language of law is unclear, factors that the State Administration of Taxation may take into account in determining tax residency include whether:

- a the offshore vehicle locates its senior management and core management departments in charge of daily operations in China;
- b financial and human resources decisions of the offshore vehicle are subject to determination or approval by individuals or bodies in China;
- c the offshore vehicle’s major assets, accounting books, company seals, and minutes and files of board and shareholders’ meetings, are kept or located in China; and
- d at least half of the offshore vehicle’s directors or senior management reside in China.

To mitigate the risk that any dividends, sale proceeds or other income received by an offshore vehicle might be subject to this tax, an offshore vehicle should take steps to establish that it is not effectively managed and controlled in China.

**Securities and Exchange Commission enforcement actions**

The Securities and Exchange Commission (SEC) Enforcement Division has continued to focus on companies with operations or activities, or both, in China but trading on US exchanges, while investigating allegations of accounting fraud has always been a focus of the SEC’s Enforcement Division. The SEC’s focus has expanded to investigating wide-ranging internal control, and books and records issues, including compliance with the Foreign Corrupt Practices Act (FCPA) at US-listed companies, as well as focusing on individual accountability. The SEC’s expanded enforcement focus has extended to Chinese companies listed in the United States, and to private equity firms based in China or with investments in China.

In 2019, the number of SEC enforcement actions related to the FCPA dropped slightly compared with the previous year, but the total settlement amount remained high. Thirteen companies paid a record US$2.47 billion to US authorities for FCPA violations. This record was largely the result of two of the largest corporate settlements in FCPA enforcement history: Ericsson (US$1 billion) and Mobile TeleSystems (US$850 million). Among the FCPA enforcement cases brought by the SEC, seven involved activities of multinational companies or their subsidiaries in China, and two involved companies’ activities in the Asia-Pacific region. Two notable cases related to China were Westport Fuels System’s US$4.1 million settlement with the SEC and Deutsche Bank’s US$16 million settlement.
In the *Westport Fuel Systems* settlement, the SEC alleged that the company, through its former CEO Nancy Gougarty, transferred shares in its Chinese joint venture to a Chinese private equity fund in which a Chinese government official had a financial interest to improperly obtain business and a cash dividend payment. The company was accused of concealing the identity of the fund in its public filings and books and records by falsely identifying a different entity as the counterparty to the transaction.\(^5\)

In the *Deutsche Bank* case, the SEC alleged that the bank hired relatives of Chinese officials and other foreign officials in Asia-Pacific and Russia to obtain investment banking business. These ‘referral hires’ bypassed Deutsche Bank's highly competitive and merit-based hiring process and were often less qualified than applicants hired through the bank’s formal hiring process.\(^6\)

The SEC also continued to focus on pursuing individual liability against senior management in 2019. On 14 November 2019, Jerry Li, a Chinese national and the former managing director of Herbalife, a US-based direct selling company, faced criminal and civil liabilities under the FCPA. The SEC alleged that Li orchestrated a scheme to bribe Chinese government officials to obtain direct selling licences and curtail a government investigation of his company’s business practices in China. Li directed that the bribes be made through payments of cash, gifts, travel, meals and entertainment, and falsified company expense reports to conceal the bribes.\(^7\) The US Department of Justice (DOJ) filed criminal charges against Li and Mary Yang, who formerly ran the external affairs department of Herbalife’s China subsidiary for reimbursing more than US$25 million for entertaining and gift-giving to Chinese government officials between 2007 and 2016.\(^8\) In addition to the underlying FCPA charges, the DOJ also charged Li with perjury for lying to the SEC and for destroying records by installing ‘wiping software’ on his company computer.

**Chinese authorities’ enforcement actions**

In addition to heightened scrutiny from US regulators, foreign private equity investors also face risks posed by Chinese authorities’ anti-corruption and antitrust enforcement actions. These risks were showcased in continued enforcement actions against multinational companies.

**Chinese anti-corruption enforcement update**

In March 2018, China formed SAMR and folded the entire State Administration for Industry and Commerce, the traditional enforcement authority for commercial bribery, into this new agency. In 2019, the local Administration for Market Regulation (AMR) in Shanghai continued its aggressive anti-corruption enforcement, imposing at least 47 administrative penalties.

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on companies and individuals. The actions covered a variety of industries (e.g., healthcare, technology, construction and logistics), with around 10.6 per cent of those penalised being multinational companies. Selected high-profile enforcement cases are summarised below.

\[a\] In March 2019, the Shanghai Songjiang AMR imposed a fine of 150,000 yuan on Daifuku (China) Logistics Equipment Co, Ltd and confiscated its illegal earnings totalling 110,505 yuan. Daifuku allegedly offered trips and entertainment to potential clients in exchange for purchase orders.

\[b\] In July 2019, the Shanghai Administrative Bureau for Industry and Commerce Inspection General Team imposed a 100,000 yuan fine on Shanghai Jiezhi Medical Apparatus and Instruments Co, Ltd (Jiezhi) and confiscated 620,432 yuan of illegal gains from the company. Jiezhi was penalised for providing free equipment to Jiangsu hospitals to facilitate its sale of medical apparatus products.

\[c\] In November 2019, the Shanghai Xuhui AMR penalised Shanghai Youlue Information and Technology Co, Ltd (Youlue) a total of 300,000 yuan for bribing physicians. Youlue allegedly paid 254,980 yuan to physicians for recommending that patients participate in its gene detective programmes.

In July 2019, the State Council announced that anti-corruption enforcement against the healthcare sector would continue to increase, with government agencies and judicial branches working jointly on actions. In line with the national policy, the local government also enacted rules to enhance scrutiny of commercial bribery. These policies appear to signal China’s determination to continue to enhance anti-corruption enforcement in 2020.

**Chinese antitrust enforcement update**

In 2019, SAMR implemented three antitrust regulations regarding monopolistic agreements, abuse of dominant market positions and abuse of administrative power (see Section II.i). These regulations provide detailed guidance relating to antitrust enforcement and are expected to promote efficiency and consistency among administrative enforcement actions.

According to MOFCOM’s 2017 annual review relating to the AML, throughout 2017, MOFCOM received 400 merger notifications (5.8 per cent more than in 2016) and closed 344 cases (12.9 per cent less than in 2016), among which MOFCOM imposed conditions on seven transactions (compared with two in 2016): the merger of Dow Chemical and DuPont; Broadcom’s purchase of Brocade; HP’s purchase of Samsung’s printer business; the merger of Agrium and Potash Corp of Saskatchewan; ASE’s purchase of SPIL; Maersk Line’s acquisition of Hamburg Sud; and Becton Dickinson’s acquisition of CR Bard. The number of MOFCOM conditional merger approvals in one year has hit a record high since the AML was promulgated. In 2017, MOFCOM imposed fines on six transactions for failure to comply with the merger notification requirements (including Canon’s acquisition of Toshiba Medical Systems Corporation and Meinian Onehealth Healthcare’s acquisition of Ciming Health Checkup, which were fined for gun-jumping in structured multi-staged transactions), which were the 14th to 19th AML penalty decisions published by MOFCOM. With the establishment of SAMR in 2018, and following internal adjustment of the scope of supervision within the Chinese government, all AML filings since mid-2018 are to be made to SAMR instead of MOFCOM. China’s antitrust enforcement continued to be aggressive in 2019, with SAMR issuing 31 penalty decisions. Ten penalties were imposed on monopolistic agreements, four related to abuses of dominant market positions and 17 related
to illegal business concentrations. The enforcement cases involve companies across multiple sectors, including automobile, energy, internet, pharmaceuticals and construction materials. High-profile enforcement cases are summarised below.

a In April 2019, Eastman (China) Investment Management Co, Ltd was fined 24.4 million yuan for abusing its dominant position in the market for alcohol used in latex paints. Eastman allegedly reached agreements with its customers requesting them to purchase 60 to 80 per cent of their annual needs from it. SAMR concluded that the arrangement violated China's antitrust laws because the agreements at issue limited customer choice and prevented other companies from entering into the alcohol market.

b In June 2019, Changan Ford Automobile Co, Ltd was fined 162.8 million yuan for setting a minimum resale price for its cars in Chongqing. SAMR found that the minimum resale prices deprived downstream dealers of pricing autonomy, excluded and restricted competition within the brand, damaged fair competition in the market and negatively impacted consumers' legal interests.

c In December 2019, SAMR imposed a penalty totalling 87.6 million yuan on Toyota Motor (China) Investment Co, Ltd. SAMR determined that Toyota's practice of setting a minimum sale and resale price for its premium Lexus cars in Jiangsu province amounted to price-fixing, deprived dealers of pricing autonomy and harmed consumer interests.

Further, at the beginning of 2020, SAMR released the Draft AML for public comment. The Draft AML imposes harsher penalties on monopolistic conduct, proposing to increase the maximum fine for monopolistic agreements from 500,000 yuan to 50 million yuan. The Draft AML also introduces criminal liabilities for individuals engaged in monopolistic conduct for the first time. The definition and scope of monopolistic agreements have been expanded to include hub-and-spoke arrangements. The proposed changes indicate that antitrust enforcement may become more aggressive in 2020.

iii Chinese outbound M&A

Chinese outbound investment approval and filing regimes

A proposed outbound investment in overseas target assets by a Chinese investor is subject to a series of outbound investment approval, filing and reporting requirements with competent Chinese authorities depending, inter alia, on the location and industry of the target assets, the investment amount, and the identity and ownership structure of the Chinese investor. An outbound investment made by Chinese individual investors through onshore or controlled offshore vehicles will be subject to relevant NDRC and MOFCOM filing or reporting mechanisms.

NDRC regulates Chinese companies’ outbound investment activities on a project-by-project basis through a multilayered approval and filing regime. Under the Administrative Measures for Enterprise Outbound Investment (Regulation No. 11), which entered into force on 1 March 2018, a Chinese investor is required to make a filing with NDRC or its local counterpart (depending on whether the Chinese investor is a centrally managed SOE and whether the investment size (including equity and debt investments made by not only the Chinese investor but also the offshore entities controlled by the Chinese investor) reaches US$300 million) and obtain an NDRC filing notice for an outbound investment transaction that does not involve a ‘sensitive country or region’ (countries and regions that are subject to investment restrictions under international treaties, war or civil commotion, or that have no diplomatic relations with China) or a ‘sensitive industry’ (which was further
clarified by NDRC in 2018 (see below for more details)), and, in cases where the transaction involves a sensitive country or region or a sensitive industry, the Chinese investor is required to apply for and obtain an outbound investment approval from the central NDRC. In addition, there has been a requirement that if the size of a Chinese outbound investment reaches or exceeds US$300 million, the Chinese investor is required to submit a project information report to NDRC and obtain an NDRC project confirmation letter before signing a definitive purchase agreement, submitting a binding offer or bid, or submitting applications with foreign governmental authorities; however, this requirement of an NDRC project confirmation letter was abolished from 1 March 2018 following the entry into effect of the new NDRC outbound rules. In addition to Regulation No. 11, NDRC promulgated a Catalogue of Sensitive Industries for Outbound Investment 2018 (the Sensitive Industries Catalogue) in January 2018, with effect from 1 March 2018. In June 2018, NDRC released the Answers to Frequently Asked Questions Concerning Outbound Investment by Enterprises (the Answers to FAQs) on its official website, providing clarification for 61 frequently asked questions regarding the application of Regulation No. 11. NDRC made rather restrictive interpretations on the scope of sensitive projects. These industries or projects include real estate, hotels, offshore equity investment funds or investment platforms without specific underlying industrial projects, sports clubs, cinemas and the entertainment industry. The designation of real estate, hotels and offshore equity investment funds or investment platforms without specific underlying industrial projects as sensitive industries has drawn substantial attention, since there were significant amounts of investment in these industries both in numbers and deal values, in the few years before 2018. Regulation No. 11 adopts a control-based approach that includes in the verification scope all sensitive projects made by offshore entities under the control of Chinese investors, regardless of whether or not the Chinese investors provide financing or guarantees for these projects. It is also notable that the restrictive interpretations of sensitive projects apply only to these three industries, namely real estate, hotels and offshore equity investment funds or investment platforms without specific underlying industrial projects, and do not include cinemas, entertainment, sports clubs or other sensitive industries. In addition to the aforementioned restrictive interpretations, the Answers to FAQs also include detailed explanations and instructions for each of the sensitive industries to clarify the scope of application of sensitive projects.

In addition to the multilayered approval and filing regime implemented by NDRC, outbound investment transactions are also subject to the reporting and filing requirements implemented by MOFCOM. Under the Interim Measures for the Recordation (or Confirmation) and Reporting of Outbound Investment (Circular No. 24), which was promulgated by MOFCOM on 8 January 2018, each Chinese investor that conducts an outbound investment transaction shall file the details of the outbound transaction made by it with MOFCOM or its local counterpart. Circular No. 24 applies the same criteria under Regulation No. 11 for the initial filing or reporting of an outbound investment transaction. In addition, Circular No. 24 further requests the Chinese investor to update its registration with respect to the approved outbound investment transaction with competent MOFCOM on a periodic basis. On 1 July 2019, MOFCOM promulgated the Implementation Regulation of Interim Measures for the Recordation (or Confirmation) and Reporting of Outbound Investment (Circular No. 24 Implementation Rules), which provides the filing requirements in detail. Under Circular No. 24 Implementation Rules, each Chinese investor shall file a semi-annual report with respect to the approved outbound investment every six months, which shall include, without limitation, the financial performance of the invested foreign
business. If the Chinese investor encounters any problem with respect to the approved outbound investment (e.g., war, governmental default, major health emergency), it shall promptly report the event to competent MOFCOM.

NDRC approvals and filings and MOFCOM initial approvals and filings are typically the pre-closing procedures on the part of Chinese investors in outbound investment transactions, particularly if the Chinese investor needs to establish an offshore subsidiary or to use onshore financing (whether equity or debt financing), or both, to complete the transaction. If a Chinese buyer uses an existing offshore entity as the acquisition vehicle and has sufficient funds offshore to complete the transaction, NDRC approvals and filings and MOFCOM initial approvals and filings, and even registration with the State Administration of Foreign Exchange (SAFE) as described below, may not be required by the parties as closing conditions (although the Chinese buyer may nevertheless go through the process of obtaining and completing NDRC approvals and filings and MOFCOM initial approvals and filings to be able to repatriate funds from the relevant investment back to China in the future). However, the aforementioned practice is restricted by the new NDRC outbound rules, which require that an investment of US$300 million or more made by an offshore entity controlled by a Chinese investor be ‘reported’ to the central NDRC, which will be a new post-closing government filing for an outbound transaction consummated by a Chinese investor’s offshore subsidiary by utilising offshore financing.

After obtaining NDRC approvals and filings and MOFCOM initial approvals and filings, a foreign exchange registration with SAFE through a local Chinese bank is required for the currency conversion and remittance of the purchase price out of China. However, this will not be applicable if a Chinese investor uses offshore capital to fund the transaction. In addition, a foreign exchange registration would be required in the case of an earnest deposit to be paid from China to overseas immediately upon or within a short period of the signing of a definitive purchase agreement. Upon registration, a Chinese investor may remit the registered amount of the deposit to offshore. However, if a Chinese investor uses its offshore funds to pay the deposit, this registration may not be applicable. The registration can be handled by a local Chinese bank concurrently with NDRC project confirmation process if the amount of the deposit does not exceed US$3 million or 15 per cent of the purchase price. Payment of deposits of higher amounts must be approved by SAFE on a case-by-case basis after completing NDRC project confirmation process.

A Chinese SOE as a buyer may also need approvals from the State-owned Assets Supervision and Administration Commission of the State Council or its local counterpart, or sometimes, alternatively, approvals from its group parent company. Depending on the transaction value and structure, a Chinese-listed company may need to obtain stockholders’ approval before closing and make the necessary disclosures required by the Chinese securities exchange rules. The State Council requires the establishment of share capital systems for SOEs and improved auditing systems to monitor SOEs’ outbound equity investments. This principle, accompanied by current rules applicable to SOEs’ investments (e.g., appraisal), are regarded as intended to preserve and increase the value of state-owned overseas assets.

Since late 2016, it has been reported that the increasing flow of Chinese outbound investment activities has become a source of concern to Chinese authorities, which have adopted more stringent control and supervision on outbound investment activities and capital flow. In an official press release dated 6 December 2016, the central governmental authorities, including NDRC, MOFCOM and SAFE, in their response to a media inquiry on tightened scrutiny over outbound investment transactions, mentioned that they had been
alerted to some irrational outbound investment activities in real estate, hotels, film studios, the entertainment industry and sports clubs, and potential risks associated with overseas investment projects involving:

a. large investments in businesses that are not related to the core businesses of the Chinese investors;
b. outbound investments made by limited partnerships;
c. investments in offshore targets that have assets of a value greater than the Chinese acquirers;
d. projects that have very short investment periods; and
e. Chinese onshore funds participating in the going-private of offshore-listed China-based companies.

Further, on 4 August 2017, the State Council issued the Guidance Opinions on Further Promoting and Regulating Overseas Investment Direction (the Guidance Opinions), which highlighted certain industry-specific guidance affecting Chinese outbound investments, including:

a. encouraging investments in overseas high-tech and manufacturing companies and in setting up overseas research and development (R&D) centres;
b. promoting investments in agricultural sectors;
c. regulating investments in oil, mining and energy sectors based on an evaluation of the economic benefits;
d. restricting investments in real estate, hotels, cinemas, the entertainment industry and football clubs; and
e. prohibiting investments in the gambling and pornography sectors.

In addition, the Guidance Opinions classify investments in offshore private equity funds or investment vehicles that do not have investment projects as restricted investments, which would be subject to pre-completion approvals by NDRC.

The tightened control on outbound investment activities and capital flow not only affects Chinese investors, but is also relevant to international private equity participants from at least two perspectives: when a private equity participant intends to partner with a Chinese investor in M&A activities outside China or when a private equity participant is considering a Chinese buyer for a trade sale as its exit route. NDRC promulgated the Sensitive Industries Catalogue in 2018, formally adopting the aforementioned measures. In these scenarios, the private equity investor must take into account the potential risk that the Chinese party may not be able to come up with sufficient funds offshore in time to complete the transaction offshore or ultimately complete the transaction. Further, when private equity investors consider a Chinese buyer as a potential exit route, in addition to the completion risk, a private equity seller would be well-advised to also consider the risk profile of the transaction and the target business in the context of Chinese regulations (including the relevant industry, the financing structure and the identity of the Chinese buyer) to evaluate the related risks and impacts, including reputational risks and social impacts, if the Chinese buyer was required to divest the business shortly after completing the transaction or was unable to provide the required funding offshore for the business, which might put stress on various aspects of the operation of the business and might also force a premature sale.
Non-Chinese investment approvals

The United States, the EU and other countries scrutinise or regulate international business activities, including relevant Chinese outbound investment activities, to achieve objectives related to, inter alia, national security, foreign investment control and anti-monopoly. In connection with Chinese investments in the United States or EU countries, the relevant parties should be aware of potential non-Chinese approvals that may be mandatory or necessary in the jurisdiction where the target is located depending on the nature and size of the transaction, which may include US and EU merger control review, and a Committee on Foreign Investment in the United States (CFIUS) review. A CFIUS review is often perceived among parties to Chinese outbound investments in the United States as one of the major foreign regulatory hurdles. The scrutiny of acquisitions by Chinese companies has been further intensified in the United States (following the reform of CFIUS legislation in late 2018) and in some other western countries.

CFIUS is an inter-agency committee of the US government that is empowered to monitor foreign direct investment in the United States by a non-US person, to evaluate whether the transaction may create national security risks. CFIUS establishes the process for reviewing the national security impact of foreign investments, joint ventures and other investments into the United States, and analyses a broad range of national security factors to evaluate whether a transaction may create a national security risk to the United States.

On 13 August 2018, US President Trump signed into law the Foreign Investment Risk Review Modernization Act (FIRRMA), which substantially reformed and expanded the jurisdiction and powers of CFIUS, including (1) expanding the jurisdiction of CFIUS, which expressly included not only controlling direct investments, but also certain non-controlling investments for the first time; (2) adopting a mandatory declaration process for certain covered transactions together with mandatory waiting periods for the closing of those transactions; (3) extending the statute timeline in respect of the review process; and (4) granting enforcement authority for CFIUS to suspend transactions. On 11 October 2018, CFIUS further promulgated a pilot programme, which took effect on 11 November 2018, strengthening and detailing regulations affecting 27 identified industry sectors (e.g., R&D in biotechnology, petrochemical manufacturing and semiconductor and related device manufacturing). To further enhance the pilot programme promulgated in October 2018, on 17 September 2019, the US Department of the Treasury promulgated the Draft Implementation Regulation of FIRRMA (the Draft FIRRMA Implementation Regulation). The Draft FIRRMA Implementation Regulation introduces the concept of a ‘technology, infrastructure and data (TID) US business’ for the first time to further emphasise the gravity and sensitivity of foreign investment in business sectors relating to intellectual property, critical infrastructure and personal data. According to the Draft FIRRMA Implementation Regulation, CFIUS further expanded its jurisdiction to all ‘covered investments’, which includes any investment made by a non-US investor in a TID US business. On 13 January 2020, the US Department of the Treasury published the finalised Draft FIRRMA Implementation Regulation, which became effective on 13 February 2020. Given that the relationship between the United States and China has deteriorated since the Trump administration took office and has dropped to a record low point due to the US–China trade war that began in 2019, FIRRMA, the pilot programmes implemented by CFIUS and the Draft FIRRMA Implementation Regulation are likely to have a dramatic and disproportionate impact on Chinese outbound investments into the United States, especially investments in highly sensitive areas (particularly, any TID US business) in the near future.
Recent major Chinese outbound investment transactions abandoned or terminated on account of CFIUS issues are listed as follows:

- **a** the abandonment in May 2018 of the US$200 million acquisition of a controlling stake in US hedge fund Skybridge Capital by HNA Group;
- **b** the abandonment in February 2018 of the US$100 million acquisition of 63 per cent shares in Cogint Inc (listed on NASDAQ) by Bluefocus due to the parties' failure to obtain CFIUS approval;
- **c** the termination in February 2018 of the US$580 million acquisition of US semiconductor testing company Xcerra Corp by Hubei Xinyan Equity Investment Partnership due to the parties' failure to obtain CFIUS approval;
- **d** the termination in January 2018 of an attempted US$1.2 billion strategic acquisition of US money transfer company MoneyGram International Inc by Chinese financial service provider and affiliate of Alibaba, Ant Financial Services Group, due to CFIUS refusal of approval over national security concerns;
- **e** the termination in November 2017 of a US$100 million investment in US financial services firm Cowen Inc by CEFC China Energy Company Limited;
- **f** the executive order issued by President Trump in September 2017 blocking a proposed US$1.3 billion sale of Lattice Semiconductor Corporation, a publicly traded US manufacturer of programmable logic chips, to a Chinese state-backed private equity firm;
- **g** the abandonment in September 2017 of the US$285 million proposed 10 per cent equity investment in HERE Technologies by a part-Chinese consortium;
- **h** the termination in July 2017 of the US$103 million acquisition of US in-flight entertainment company Global Eagle by the Chinese conglomerate HNA due to the parties' inability to obtain CFIUS approval;
- **i** the executive order issued by President Obama in December 2016 blocking the proposed acquisition of German semiconductor manufacturer Aixtron SE's US business by a group of Chinese investors led by Fujian Grand Chip Investment Fund LP;
- **j** the termination in January 2016 of the attempted acquisition of Philips NV’s Lumileds LED business by a consortium of Chinese investors led by GO Scale Capital due to the parties' failure to address national security concerns raised by CFIUS;
- **k** the termination in February 2016 of the proposed investment in Western Digital by Unis Union and Unisplendour after CFIUS determined to investigate the transaction; and

Due to the aggressive CFIUS policies, large cross-border investment attempts by Chinese investors in the US market almost dried up in 2019. As a result, there is no relevant data to report for 2019. In addition to the United States, other western countries have tightened control over investment by Chinese companies in certain sensitive industries, which has resulted in the termination of certain acquisition attempts by Chinese companies. Germany enacted an amendment to the German Foreign Trade and Payments Ordinance (AWV) in July 2017, pursuant to which any acquisition of at least 25 per cent voting rights of German companies by a non-European Economic Area investor is subject to a foreign investment control approval by the German government. On 20 December 2018, Germany promulgated
a new amendment to the AWV, lowering this threshold to 10 per cent for certain investments in ‘critical infrastructure’ or ‘military-related products’ industries. Notable examples of failed attempts by Chinese companies in Germany include an attempted takeover of the Westphalian mechanical engineering company Leifeld Metal Spinning on 1 August 2018 by Yantai Taihai, a leading participant in the Chinese nuclear sector.

III YEAR IN REVIEW

i Recent deal activity

Going-private transactions

The trend of US-listed Chinese companies going private heated up to record levels in 2015 and 2016, retreated from these peak levels in 2017 and cooled down further in 2018 and 2019. Based on statistics obtained through searches on Thomson ONE:

a during 2014, four US-listed going-private transactions were announced (with all four withdrawn) and three were closed;
b during 2015, eight US-listed going-private transactions were announced (with seven withdrawn) and 18 were closed;
c during 2016, eight US-listed going-private transactions were announced (with five withdrawn) and six were closed; and
d during 2017, three US-listed going-private transactions were announced and one was closed;
e during 2018, five US-listed going-private transactions were announced (with one withdrawn); and
f during 2019, four US-listed going-private transactions were announced and none were closed.

The struggle by some Chinese companies against market research firms and short sellers such as Muddy Waters Research, Citron Research and Blue Orca Capital has often provided interesting perspectives on the environment faced by Chinese companies listed in the United States. These market research firms and short sellers have gained name recognition by issuing critical research reports targeting Chinese companies listed in the United States. The business model of such firms appears to involve issuing negative research reports on a public company while simultaneously taking a short position in the company’s stock, which often enables these firms to make substantial profits even if their research and accusations are not ultimately proven correct. Notably, these firms have not limited their coverage to companies listed through reverse takeovers (RTOs), which are commonly considered to have lower profiles and to be more prone to disclosure issues than companies listed through a traditional IPO process.

Following the consequential coverage by Muddy Waters of Orient Paper Inc in 2010 and Sino-Forest Corp in 2011, the most notable case in 2012 arose when, on 18 July 2012, Muddy Waters published a scathing report on New Oriental Education & Technology

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9 In a typical RTO, a private company merges with a publicly traded company (often a shell having limited assets and operations at the time of the RTO), whereby the private company injects its assets into the public company and the shareholders of the private company become controlling shareholders of the public company. As a result of the merger, the (formerly) private company’s business essentially becomes listed without that company having paid the cost or gone through the vigorous vetting process or fulfilled the burdensome disclosure requirements of an IPO.
Group Inc on its website, sinking the company’s share price to US$9.50 by 35 per cent in one day. New Oriental is widely considered one of the more reputable and well-run Chinese companies listed in the United States, and it went public in a traditional IPO. The company’s stock price subsequently recovered to US$13.90 one and a half months after the Muddy Waters report came out, suggesting the market’s belief that the accusations were not justified. New Oriental’s stock, at the time of writing, trades at US$136.88. On 14 November 2018, Blue Orca Capital issued a short-selling report, accusing Pinduoduo Inc, a social commerce company in China, of inflating revenues and falsely trimming losses. Blue Orca Capital predicted a 59 per cent drop in the company’s stock price in its negative report, whereas Pinduoduo’s stock price experienced a surge after the announcement of its quarterly result following Blue Orca Capital’s report, suggesting that investors in the US market as a whole can act quite independently of such negative research reports and short-selling attempts. On the other hand, on 24 October 2013, Muddy Waters published an 81-page report labelling Beijing-based mobile provider NQ Mobile Inc a ‘massive fraud’, sending the company’s share price tumbling more than 60 per cent in three days. NQ Mobile’s share price experienced substantial recovery during the fourth quarter of 2013 and the first quarter of 2014 but lost more than 80 per cent in value amid continued attacks from Muddy Waters and traded below US$4 (or less than one-fifth of its 2013 high) for most of 2017. NQ Mobile Inc was eventually delisted from the New York Stock Exchange (NYSE) on 9 January 2019.

Regardless of the ultimate outcome, the fact that a single research report could inflict sudden and substantial damage of this nature on a company’s reputation and stock price strongly suggests a widespread underlying lack of confidence in listed Chinese companies. The success of these research and short-selling firms could also be partially attributed to a lack of access to and understanding of the Chinese business environment and markets, which have afforded a few firms that have conducted on-the-ground research outsize influence in the market. Further, their critical coverage, which often involves allegations of disclosure issues or even fraud, has attracted regulatory attention and shareholder lawsuits and may have encouraged less-than-generous media coverage of Chinese companies in general. For instance, in 2013, the SEC publicised its investigations and charges against US-listed China MediaExpress and its chair and CEO for fraudulently misrepresenting the company’s financial condition to investors in SEC filings dating back to November 2009, and against RINO International Corporation, a China-based manufacturer and servicer of equipment for China’s steel industry, and its chair and CEO for a series of disclosure violations based on accounting improprieties, after (or shortly before) Muddy Waters initiated coverage and issued negative reports regarding these companies. The above factors, in turn, are believed to have contributed to suppressed valuations of US-listed Chinese companies in general.

Amid continued pressure from regulators, unfavourable media coverage, short-selling activities and shareholder lawsuits, the stock prices of many US-listed Chinese companies are perceived to be consistently depressed. Further, even Chinese companies relatively free of negative coverage have often felt that their business model and potential are not fully appreciated by the US market, and that they would be more favourably received by a market closer to China – for example, the Hong Kong Stock Exchange or the Chinese A-share market – where market research and media coverage are seen as being more positive and reflecting a proper appreciation of the business culture and environment in China, resulting in a better understanding of the specific business models and potential of the companies covered. At the same time, the booming domestic Chinese stock market (with an average price-to-earnings (P/E) ratio of 14.55 at the end 2019, 12.49 at the end of 2018, 18.08 at
the end of 2017, 15.91 at the end of 2016 and 17.61 at the end of 2015 for A-share listed companies listed on the Shanghai Stock Exchange, and an average P/E ratio of 26.15 at the end of 2019, 20 at the end of 2018, 36.21 at the end of 2017, 41.62 at the end of 2016 and 53.34 at the end of 2015 for A-share listed companies listed on the Shenzhen Stock Exchange) often offered valuations several times over those offered in the United States.

The disparity in valuation levels and perceived receptiveness naturally presented a commercial case for management and other investors to privatise US-listed Chinese companies, with the hope of relisting them in other markets. One of the most significant going-private transactions to date was the proposed acquisition of Qihoo 360 Technology Co Ltd by a consortium consisting of its co-founder and chair, Mr Hongyi Zhou, its co-founder and president, Mr Xiangdong Qi, and certain other investors, in a transaction valuing the NYSE-listed company at approximately US$9.3 billion (not taking into account rollover shares to be cancelled for no consideration). This deal was closed in July 2016 and was the largest privatisation of a US-listed Chinese company (the second-largest being the take-private of Qunar Cayman Islands Ltd by Ocean Imagination LP, which was signed in 2016, valuing Qunar at US$4.59 billion).

While earlier going-private transactions involving US-listed Chinese companies tended to run more smoothly, some more recent transactions of this type went through more eventful processes, suggesting the challenges in completing such transactions have been increased by a more competitive dealmaking environment with a shrinking pool of desirable targets and a more seasoned shareholder base. For example, in the going-private transaction of NASDAQ-listed Yongye International Limited, the initial bid of the buyer consortium led by Morgan Stanley Private Equity Asia and the company’s CEO failed to receive the requisite shareholders’ approval, and the transaction was approved in a subsequent shareholder meeting only after the buyer consortium raised its bid by 6 per cent. In the going-private transaction of hospital operator Chindex International Inc, the initial offer of US$19.50 per share from the buyer consortium comprising Shanghai Fosun Pharmaceutical, TPG and the company’s CEO was countered by a rival offer of US$23 per share received by the company in the ‘go-shop’ period, and the buyer consortium eventually had to raise its offer to US$24 a share to secure the transaction, raising the total price tag to US$461 million. A more recent case that has been drawing market attention is iKang Healthcare. While the iKang special committee was considering a going-private proposal submitted in August 2015 by a consortium led by Ligang Zhang, its founder, chair and CEO, and FountainVest, in November 2015 the iKang board received a competing proposal from a consortium led by one of iKang’s main competitors, Meinian Onehealth Healthcare (Group) Co, Ltd, a Shenzhen-listed company. The founder-led consortium and the Meinian-led consortium then engaged in an intense publicity war, iKang’s board adopted a poison pill and Meinian increased its offer price for the second time. In June 2016, after the board of directors of iKang received a competing go-private proposal from Yunfeng Capital (a private equity firm co-founded by Alibaba Group Holdings Ltd’s Jack Ma and Focus Media Holdings’ David Yu) to acquire the entire share capital in iKang, both the founder-led consortium and the Meinian-led consortium withdrew their going-private proposals. After 21 months’ negotiation, a reorganised consortium led by Yunfeng Capital, Alibaba Group Holdings and BOYU Capital, Ligang Zhang and Boquan He, the vice president of iKang, managed to enter into a merger agreement on 26 March 2018, pursuant to which the reorganised consortium proposed an offer at US$41.20 per share (or US$20.60 per American depositary share of the company (ADS)), with a total value of approximately US$1.097 billion. This offer was
approved by iKang’s general shareholders’ meeting on 20 August 2018, and the merger was closed and officially announced on 18 January 2019. In addition, recently, a potential going-private deal of China Biologic Products Holdings, Inc (Biologic), a leading blood plasma-based biopharmaceutical company, caused public attention. In September 2019, Biologic announced that it had received a take-private proposal for US$4.59 billion in cash from a consortium of buyers (including Beachhead Holdings Limited, CITIC Capital China Partners IV, LP, PW Medtech Group Limited, Parfield International Ltd, HH Sum-XXII Holdings Limited and V-Sciences Investments Pte Ltd). The details of the deal are yet to be published given that the proposed transaction is under negotiation at the time of writing.

The going-private trend was not limited to entities resulting from an RTO. While companies listed through RTOs may be easier targets of short sellers, companies that listed in the United States through a conventional offering may be more appealing targets for private equity investors given that these companies are often perceived to be of higher quality and less likely to have accounting or securities law compliance issues, and thus are more likely to grab a higher valuation later on, whether in an IPO in a market closer to China or a trade sale. Indeed, all of the examples discussed above involved companies listed through a traditional IPO.

A majority of US-listed China-based companies involved in going-private transactions in recent years are incorporated in the Cayman Islands. Two out of four US-listed China-based companies that announced receipt of a going-private proposal in 2019 were Cayman Island companies that accessed the public markets through a conventional IPO, compared with one Cayman Islands company out of five US-listed China-based companies in deals announced in 2018, one Cayman Islands company out of three US-listed China-based companies in deals announced in 2017, six Cayman Islands companies out of eight US-listed China-based companies in deals announced in 2016, seven Cayman Islands or British Virgin Islands companies out of eight US-listed China-based companies in deals announced in 2015, and four Cayman Islands or British Virgin Islands companies out of four China-based companies in deals announced in 2014. This was driven in part by the introduction of new merger legislation in the Cayman Islands in April 2011, which made statutory merger under the Cayman Islands Companies Law an attractive route to effect a going-private transaction. The merger process typically requires the buyer group to form a new Cayman Islands company that will merge with, and be subsumed by, the listed Cayman target. Under the 2011 amendments to the Cayman Islands Companies Law, the shareholder approval threshold for a statutory merger was reduced from 75 per cent to a two-thirds majority of the votes cast on the resolution by the shareholders present and entitled to vote at a quorate meeting, in the absence of any higher threshold in the articles of association of the target company. In additional, a merger under the Cayman Islands Companies Law is not subject to the ‘headcount’ test required in a scheme of arrangement, the primary route for business combination under the Cayman Islands Companies Law before merger legislation was introduced in the Cayman Islands. The headcount test requires the affirmative vote of ‘a majority in number’ of members voting on the scheme, regardless of the amount or voting power of the shares held by the majority, which means that a group of shareholders holding a small fraction of the target’s shares could block a transaction. The lower approval threshold makes mergers an attractive option when compared with either a ‘squeeze-out’ following a takeover offer, which would require the buyer to obtain support from 90 per cent of the shares, or a scheme of arrangement, which would involve substantial closing uncertainty on account of the headcount test, as well as added time and costs arising from the court-driven process.
Most of the going-private transactions that closed in 2018 and 2017 took between two and five months from the signing of definitive agreements to closing (the rest took five months or longer) and were structured as a one-step, negotiated merger (as opposed to a two-step transaction consisting of a first-step tender offer followed by a second-step squeeze-out merger, which is another common approach to acquire a US public company). In a one-step merger, a company incorporated in a US state will be subject to the US proxy rules, which require the company to file a proxy statement with the SEC and, once the proxy statement is cleared by the SEC, to mail the definitive proxy statement to the shareholders and set a date for its shareholders’ meeting. Transactions involving affiliates (e.g., management) are further subject to Rule 13e-3 of the Securities and Exchange Act, and are commonly referred to as ‘13e-3 transactions’. A 13e-3 transaction requires the parties to the transaction to make additional disclosures to the public shareholders, including as to the buyer’s position on the fairness of the transaction. An important related impact is that, whereas the SEC reviews only a fraction of all proxy statements, it routinely reviews disclosure in 13e-3 transactions, which can lengthen the transaction process by several months. Further, companies incorporated outside the United States and listed on US stock exchanges (including recent going-private targets that often are incorporated in the Cayman Islands or the British Virgin Islands) are known as foreign private issuers (FPIs). While FPIs are not subject to the proxy rules, they are subject to 13e-3 disclosure obligations, and if they are engaged in a 13e-3 transaction, they would be required to include as an exhibit to their 13e-3 filings information that is typically very similar to a proxy statement prepared by a US domestic issuer. Accordingly, both a transaction involving a US domestic company and a 13e-3 transaction involving an FPI follow a comparable timetable for purposes of SEC review.

The recent tightening of control on capital flows out of China, including regulations restricting Chinese onshore funds from participating in the going-private of offshore-listed China-based companies may also create hurdles for going-private transactions of offshore-listed China based companies as these transactions typically involve buyer parties or financing, or both, from China. It remains to be seen how long the tightened control on outbound capital flow will last and its exact impact on going-private transactions involving Chinese companies.

Another key recent trend in going-private transactions of US-listed Chinese companies that are incorporated in Cayman is the rise of dissenting shareholders in such deals. Many of the US-listed and Cayman-incorporated Chinese companies that have recently gone private are facing dissenting shareholder litigations under Section 238 of the Companies Law of the Cayman Islands by investors who claim that their shares are worth more than the offer price. Often, the buyer groups are accused of forcing through low-ball offers by virtue of their significant voting rights. Low-ball offers are possible partially because Cayman Islands law allows buyer groups to vote their shares, including super voting shares, together with the other shareholders, towards the two-thirds in voting power represented by shares present and voting at the shareholders’ meeting required for approval of the merger. For example, the buyer groups in the take-private of Mindray and Shanda Games held 63.1 and 90.7 per cent, respectively, in voting rights in the relevant target companies. Some private equity shareholders in going-private transactions have publicly complained or made Schedule 13D filings with the SEC about low-ball offers from Chinese buyout groups.

In January 2017, the Cayman Islands Grand Court delivered its interlocutory judgment regarding the Blackwell Partners LLC v. Qihoo case, in which it decided that interim payments could be requested by dissenting shareholders and granted by the court during the judicial proceedings for the merger transactions initiated under Section 238 of the Companies Law.
of the Cayman Islands. In April 2017, the Cayman Islands Grand Court delivered its ruling in the *Shanda Games* case, in which it found that the fair value of the shares owned by the dissenting shareholders (which were all funds managed by Hong Kong-based fund manager Maso Capital) was more than double the consideration offered in the take-private scheme. These decisions, in hindsight, are perceived to be instrumental in shaping the dissenting shareholder landscape in the Cayman Islands. The *Shanda Games* case was the second Cayman court decision on fair value in a merger, and the first one that required the Cayman court to determine the value of a company with assets and business operations in China. While the *Shanda Games* decision further propped up expectations of dissenting shareholders of a court-determined fair value that is substantially higher than the price offered by the buyer group, the *Qihoo* decision (together with a few other similar decisions) perhaps dealt the more decisive blow by enabling the dissenting shareholders to recover interim payments (which are often equal to the price offering in the take-private) relatively soon after initiation of litigation, significantly reducing the cost of funds for dissenting shareholders.

Currently, several similar additional cases are pending in the Cayman Islands courts, and it remains to be seen whether future Cayman court decisions will balance market expectations and discourage speculative dissenters. One of the cases demonstrating these balancing efforts is the decision of the Cayman Islands Grand Court in the going-private transaction of eHi Car Services Ltd (eHi), the provider of passenger car rental services in China. In June 2018, the Cayman Islands Grand Court decided that the dissenting minority shareholder of eHi could not pursue a winding-up petition intended to delay, or to gain leverage for, a competing merger bid for the privatisation of eHi. To compete against a proposal at US$13.35 per ADS offered by a consortium led by Baring Private Equity Asia Limited and Ruiping Zhang, the chairman of eHi group, Ctrip Investment Holding Ltd, a dissenting minority shareholder of eHi, submitted a counter proposal at US$14.50 per ADS. This proposal, although at a higher offer price, was not recommended by the special committee to the board of directors of eHi because it was considered to be a last-minute increase from the price offered in the proposal submitted by Baring and the chairman. Ctrip Investment Holding Ltd then presented a winding-up petition together with an immediate injunction to the Cayman Islands Grand Court. The Court struck out the winding-up petition in its entirety on the ground of abusive use of the winding-up jurisdiction by the dissenting shareholder. Although a reorganised consortium led by Ctrip Investment Holding Ltd and Ocean Imagination LP eventually won the competing bid with a revised proposal at US$15.50 per ADS in May 2018, the Cayman Islands Grand Court’s decision in this case now stands as an exemplary case for the principle that a winding-up petition may not be abusively used by dissenting shareholders to avoid a going-private transaction.

**Other notable transactions**

Consolidations in the vying internet and technology industries in China have been soaring and hitting headlines for several consecutive years. In February 2015, Didi Dache and Kuaidi Dache, two of China’s leading ride-hailing apps, announced their US$6 billion stock-for-stock merger, which was closed weeks thereafter, creating Didi Kuaidi (later rebranded as Didi Chuxing), one of the world’s largest smartphone-based transport service providers. In August 2016, Didi Chuxing announced its acquisition of Uber China (Uber’s China business), which was valued at around US$8 billion, and after the transaction, Didi Chuxing was estimated to be worth around US$35 billion. Uber obtained a 17.7 per cent stake in Didi Chuxing and became the largest shareholder of Didi Chuxing, with other existing investors
in Uber China, including Chinese search giant Baidu Inc, taking another 2.3 per cent stake in Didi Chuxing. In April 2015, NYSE-listed 58.com purchased a 43.2 per cent fully diluted equity stake in Ganji.com for US$1.56 billion, initiating the long-term strategic combination of these two major online classified providers in China. In October 2015, two major online-to-offline (O2O) service providers in China, the group-buying service Meituan.com and restaurant review platform Dianping Holdings, announced a merger to create a US$15 billion giant player in China's O2O market covering restaurant review, film booking and group buying businesses. In late October 2015, China's largest online tourism platform, Ctrip, announced the completion of a share exchange with Baidu, Inc through which it gained control of its rival Qunar. The transaction formed a dominant player in the online trip booking market in China valued at US$15.6 billion. In January 2016, Meishu.com, a Chinese fashion retailer backed by Tencent Holdings Ltd announced its merger with its chief rival, Mogujie.com, to form the biggest fashion-focused e-commerce service provider in China with a valuation of nearly US$3 billion. In September 2017, the merger of two major online film-ticketing platforms was announced between Maoyan (majority-owned by Chinese television and film company Enlight Media) and Weying (backed by Tencent). Following the merger, the combined Maoyan-Weying entity will control 43 per cent of China's online ticketing market, according to Enlight Media's announcement. In April 2018, Ele.me, a leading online food order and local delivery services platform in China, announced the completion of its merger into Alibaba Group Holdings Limited (Alibaba), with a valuation of US$9.5 billion. Following the merger, Ele.me has become a part of the Alibaba ecosystem by complementing Alibaba's current local services platform, Koubei, and providing extended synergies to Alibaba's new retail business sector in the long run. In September 2019, Kaola.com, a leading cross-border e-commerce platform in China, announced the completion of its merger into Alibaba Group Holdings Limited (Alibaba), with a valuation of US$2 billion. Kaola.com was one of the biggest competitors of Tmall.com (the core cross-border e-commerce platform of Alibaba) in the field of cross-border e-commerce business in China. Upon the merger, Kaola.com retains its trade name and independent operations, while the management team of Tmall.com took charge of the corporate governance of Kaola.com.

In addition to the iconic mergers described above, the headline private equity investments in 2018 primarily focused on China's technology industries. In April 2018, Pinduoduo Inc, the leading ‘new-e-commerce’ platform, which features a team purchase model, announced the completion of its pre-IPO financing at a valuation of US$15 billion with Sequoia Capital and Tencent Holdings. In June 2018, Ant Financial Services Group, the leading online payment service provider and the financial arm of the Alibaba Group, announced the completion of its US$14 billion Series C financing (with a valuation of US$150 billion) from a series of private equity and sovereign funds, including Baillie Gifford & Co, BlackRock Private Equity Partners, Canada Pension Plan Investment Board, The Carlyle Group, General Atlantic LLC, GIC Special Investments, Janchor Partners, Khazanah Nasional Bhd, Sequoia Capital, Silver Lake Partners, T Rowe Price, Temasek Holdings and Warburg Pincus. In October 2018, ByteDance/Toutiao, the leading internet content platform in China, announced the completion of its pre-IPO financing at a valuation of US$75 billion from leading global private equity funds, including General Atlantic, KKR, Primavera and SoftBank. In 2019, the highlights of private equity investments still targeted China's information technology industries. In February 2019, Chehaoduo Group (Guazi.com/Maodou.com), the leading e-commerce platform for used vehicles in China, announced the completion of its pre-IPO financing at a valuation of US$1.5 billion with
SoftBank Investment Advisers. In November 2019, Cainiao Network Technology, one of the leading internet-based logistic service providers in China, announced the completion of its US$3.3 billion Series B financing pursuant to which Alibaba became the largest and controlling shareholder of the company. In December 2019, Kuaihu.com, the leading short video content provider and social platform in China, announced the completion of its pre-IPO financing at a valuation of US$3 billion from a series of private equity investors, including Boyu Capital, Sequoia Capital, Yunfeng Capital, Tencent and Temasek Holdings.

Another noteworthy trend in recent years has been private equity investors' participation in the mixed ownership reform of China's SOEs, where Chinese SOEs introduce private investors as minority shareholders. The highlight of this trend was the US$2.4 billion acquisition in 2014 of a 21 per cent equity interest in China Huarong Asset Management Co, Ltd, one of the largest asset management companies in China that was listed on the Hong Kong Stock Exchange in 2015 by a consortium of investors including China Life Insurance (Group) Company, Warburg Pincus, CITIC Securities International Company Limited, Khazanah Nasional Berhad, China International Capital Corporation Limited, China National Cereals, Oils and Foodstuffs Corporation, Fosun International Ltd and Goldman Sachs. Warburg Pincus was reported to have bought the largest portion of a 21 per cent stake for close to US$700 million. In August 2017, Wealth Capital, a Beijing-based private equity firm, set up a 5 billion yuan investment fund in Beijing targeting SOEs undergoing mixed ownership reform, in which the state-backed China Structural Reform Fund (a 350 billion yuan SOE restructuring fund backed by investors including China Chengtong Holdings Group, China Merchants Group and China Mobile) has invested and Wealth Capital acts as the fund manager, which is just one of many similar SOE reform-targeted funds that are being set up by state-owned capital and private equity funds across China.

### Financing

Third-party debt financing continues to be available for acquisitions of Chinese companies by private equity investors. One key challenge, however, is that a Chinese target does not generally have the ability to give credit support (by way of guarantee or security over its assets) to a lender of offshore acquisition debt financing. Further, with a view to deleveraging and strengthening the economy, the Chinese authorities imposed various new foreign debt controls in 2018, which will impact the availability of security and financing to be provided by Chinese entities and financial institutions. For instance, insurance companies have been restricted from providing outbound guarantees for offshore debt; domestic Chinese companies raising foreign debt have been subject to higher governance standards; local government entities have been prohibited from providing outbound guarantees for offshore borrowing and real estate companies have been restricted from using foreign debt in relation to real estate projects.

Many of the going-private transactions of US-listed Chinese companies involved debt financing, with the terms of the financings reflecting various commercial and structural challenges. The acquisition debt is typically borrowed by an offshore acquisition vehicle with the borrower giving security over its assets (including shares in its offshore subsidiaries, including the target) to secure repayment of the debt. As was the case in 2011 and 2012, the typical lender in these transactions spanned a wide range of financial institutions, from international investment banks to Chinese policy banks and offshore arms of other Chinese banks.
The Focus Media financing remains the standout transaction among debt-financed going-private transactions, due mainly to the size (US$1.52 billion) and complexity of the debt-financing facility, and the large consortium of both major international banks (Bank of America Merrill Lynch, Citibank, Credit Suisse, DBS Bank, Deutsche Bank and UBS) and offshore arms of Chinese banks (China Development Bank, China Minsheng and ICBC) that provided the financing. The 7 Days Inn financing was another notable debt-financed going-private transaction that was largely financed by a syndicate of Asian banks (Cathay United Bank, China Development Industrial Bank, CTBC Bank, Entie Commercial Bank, Nomura, Ta Chong, Taipei Fubon Commercial Bank, the Bank of East Asia and Yuanta Commercial Bank). The debt financing for the Giant Interactive take-private was also underwritten and arranged by a large syndicate of banks, including China Minsheng Banking Corp, BNP Paribas, Credit Suisse, Deutsche Bank, Goldman Sachs, ICBC International and JP Morgan, in an aggregate amount of US$850 million. It can perhaps be considered a positive signal for any future going-private transactions that such a large number of financiers were comfortable to commit to funding this type of event-driven financing.

One notable development since 2015 is reflected in the going-private of Qihoo. Rather than obtaining the debt financing in US dollars offshore, the entire financing of a yuan equivalent of approximately US$3.4 billion was provided by one Chinese bank (China Merchants Bank (CMB)) onshore in yuan, with the buyer group having obtained the required Chinese regulatory approvals to convert the yuan funded by CMB into US dollars for payment of consideration to Qihoo’s shareholders offshore. It remains to be seen whether this relatively novel deal structure will gain popularity, as both Chinese regulatory authorities and financial institutions gain more familiarity with this type of take-private transaction involving US-listed and China-based companies. The tightened control over outbound capital flow since late 2016 discussed above may deter the wide usage of this type of financing structure.

Another emerging trend in these offshore financing structures is that borrowers are seeking to access liquidity from the offshore debt markets in respect of what are essentially acquisitions of Chinese-based businesses – including as a means to take out bridge financing originating outside Asia.

iii Key terms of recent control transactions

Deal terms in going-private transactions

Most Chinese going-private transactions have involved all-cash consideration. Among the US-listed going-private transactions that closed during 2017, the per-share acquisition price represented an average premium of 17.5 per cent over the trading price on the day before announcement of receipt of the going-private proposal, according to statistics obtained through searches on Thomson ONE.

In a 13e-3 transaction (the going-private of a US-listed company involving company affiliates), the board of directors of the target typically appoints a special committee of independent directors to evaluate and negotiate the transaction and make a recommendation to the board. If the target is incorporated in the United States, the transaction almost inevitably will be subject to shareholders’ lawsuits, including for claims of breaches of fiduciary duties, naming the target’s directors as defendants. Because the target’s independent directors often include US residents, a key driver of a transaction’s terms is the concern for mitigating shareholders’ litigation risk. Although no litigation claims for breach of fiduciary duties in a Chinese going-private transaction involving Cayman Islands or British Virgin Islands companies were reported to the public in 2017, it remains possible that, as the going-private
trend persists, plaintiffs’ firms will begin to articulate creative arguments in Cayman mergers and the Cayman courts may look to the body of Delaware law as persuasive precedent for adjudicating claims of breach of fiduciary duties. As a result, whether a going-private transaction involves a US or Cayman-incorporated target, targets typically insist that certain key merger agreement terms (in addition to the deal process) be within the realm of what constitutes the ‘market’ for similar transactions in the United States.

An important negotiated term in many going-private transactions is the required threshold for shareholder approval. Delaware law requires that a merger be approved by shareholders owning a majority of the shares outstanding. However, special committees often insist on a higher approval threshold, because under Delaware law the burden of proving that a going-private transaction is ‘entirely fair’ to the unaffiliated shareholders often shifts from the target directors to the complaining shareholders if the transaction is approved by a majority of the shareholders unaffiliated with the buyer group (i.e., a ‘majority of the minority’). In US shareholder litigations, this burden shift is often seen as outcome-determinative. Under Cayman law, there is no well-defined benefit for the company to insist on a higher approval threshold than the statutory requirement of two-thirds of the voting power of the target present at the shareholders’ meeting.

Another key negotiation point is whether the target would benefit from a go-shop period, which is a period following the signing of a transaction agreement during which the target can actively solicit competing bids from third parties. When defending against a claim of breach of fiduciary duty in Delaware, a company and its directors may point to a go-shop period in a merger agreement as a potentially helpful fact. Under Cayman law, however, there is not as much well-defined benefit for the company to insist on a go-shop period if the buyer consortium already has sufficient voting power to veto any other competing merger proposal.

**Deal terms in growth equity investments**

Deal terms are more difficult to evaluate and synthesise in private transactions, where terms are not publicly disclosed. Generally, in the context of a growth equity investment (which, as we have seen, remains the dominant type of deal both by number of deals and by aggregate amount invested), private equity investors often continue to expect aggressively pro-buyer terms. This expectation applies whether a transaction involves an onshore Sino-foreign joint venture or an investment offshore alongside a Chinese partner. In a subscription agreement for a growth equity deal, an investor typically benefits from extensive representations and warranties against which the company makes only limited disclosures; in some cases, an investor has knowledge that some representations may not be accurate, but still insists on a representation to facilitate a potential indemnification claim later. It is not uncommon for an investor to also enjoy an indemnity provision with a cap on the amount of losses subject to indemnification as high as the purchase price (or no cap at all), but with no deductible or threshold and with an unlimited survival period. Shareholders’ agreements often contain similarly pro-investor terms, such as extensive veto rights (even in the case of a relatively small minority stake) and various types of affirmative covenants binding the company and its Chinese shareholders. If an investment is structured offshore (e.g., through a Cayman company that owns a Chinese subsidiary), a private equity investor may enjoy ‘double-dip’ economics pursuant to which, in the event of a liquidation or sale of the company, the investor is entitled to, first, a liquidation preference before any of the Chinese shareholders receive any proceeds and, second, the investor’s pro rata share of the remaining proceeds based on the number of shares it owns on an as-converted basis. However, because there is no well-defined market
when it comes to transaction terms in Chinese growth equity deals (unlike in going-private transactions), issuers also have opportunities to request, and sometimes obtain, terms that are very favourable to them. In growth equity deals in China, investors typically seek valuation adjustments or performance ratchet mechanisms, which can be structured as the adjustment to conversion prices of preferred shares that may be exchanged into a larger number of common shares at offshore level, or by compensation or redemption of equity interest in cash or transfer of equity interest to investors by the founders or original shareholders at onshore level without consideration or with nominal consideration, so as to achieve adjusted valuation of the target company following the failure to meet specified performance targets. In Chinese growth equity investments, the parties’ leverage and degree of sophistication are more likely to dictate the terms that will apply to a transaction than any market practice or standard. In recent years, growth equity investments into high-growth technology companies have begun to contain less investor-friendly deal terms (e.g., new investors receiving pari passu liquidation preference with previous investors) as competition among private equity firms to make investments into this sector continues to heat up.

For a private equity investor with sufficient commercial leverage, the key challenge often lies not in convincing the investee company or its Chinese shareholders to agree to adequate contractual terms, but rather in getting comfort that an enforceable remedy will be available in the event that the Chinese counterparty reneges on its contractual obligations. One potential antidote to the difficult enforcement environment onshore is to seek a means of enforcement offshore. An investor can get comfort if it obtains, for example, a personal guarantee of the Chinese founder backed by assets outside China, governed by New York or Hong Kong law and providing for arbitration in Hong Kong as a dispute resolution venue. Such a guarantee, however, is rarely available (because the Chinese founder may not have assets outside China), and even when potentially available, is often unacceptable to the founder. A more realistic alternative is for a private equity investor to seek the right to appoint a trusted nominee in a chief financial officer or similar position (who could monitor an investee company’s financial dealings and compliance with its covenants to its shareholders). An investor may also seek co-signatory rights over the target company’s bank account, in which case an independent third party (the bank) will ensure that funds are not released other than for purposes agreed to by the investor.

iv Timetable
Among the US-listed going-private transactions that closed during 2017 and 2018, the parties took an average of five months from the announcement of the going-private proposal to reach definitive agreement, and a further three months on average from signing the definitive agreement to close the transaction. Typically, the pre-signing timetable is less predictable and to a large extent driven by negotiation dynamics, the finalisation of the members of the buyer consortium, arrangement of financing and the parties’ willingness to consummate the deal, which in turn is affected by market conditions, availability of equity and debt financing, and various other factors. On the other hand, the post-signing timetable is typically largely driven by the SEC review process and shareholders’ meeting schedule, and as a result is relatively more predictable. That being said, the going-private of Shanda Games took more than seven months from the signing of the definitive agreement to closing, substantially longer than what is typically required of the SEC review and shareholder approval processes, because of, inter alia, changes in the composition of the buyer consortium after signing. The going-private of Qihoo and Xueda Education each also took more than seven months from the
signing of the definitive agreement to closing, reportedly because of the procedures required to obtain outbound investment regulatory approvals, to complete the conversion of renminbi financing into US dollars offshore and to complete other governmental formalities relating to relevant Chinese onshore buyers. While these are more exceptions than the norm, these transactions do flag for market participants the significant time and resource commitments required of participants in a going-private transaction, and the ever-changing dynamics of market demand and within the buyer consortium (including the time to have all the necessary funds in place), all of which are factors that could affect the timetable to completion.

v Exits
At the forefront of the privatisation wave in the US and Chinese markets, Focus Media achieved a 45.7 billion yuan backdoor listing on the Shenzhen Stock Exchange in December 2015 through Hedy Holding Co Ltd after a reverse merger, which followed Focus Media’s 2013 going-private and de-listing from the United States led by a consortium of private equity investors. This deal represented the first re-listing of a once-NASDAQ listed company on the A-share market, and has blazed a trail for US-listed Chinese companies seeking to go private and thereafter relist in Chinese domestic market. Giant Interactive achieved an 13.1 billion yuan backdoor listing on the Shenzhen Stock Exchange in April 2016 through Chongqing New Century Cruise Co Ltd after a reverse merger, which followed Giant Interactive’s 2014 going-private and de-listing from the US led by a consortium consisting of Giant Interactive’s chair Shi Yuzhu and private equity investors, including Baring Private Equity Asia, Hony Capital and CDH Investments, making Giant Interactive the first once-US listed Chinese online game company getting relisted on the A-share market. Qihoo, after its largest going-private of a US-listed Chinese company to date, has received the Chinese securities regulatory authority’s approval for a relisting in China under the new name of Technology 360 through back-door listing via Shanghai-listed Jiang Nan Jia Jie.

As US listings of Chinese companies picked up in 2016, the Shanghai-based logistics company ZTO Express, backed by Sequoia Capital as an early stage investor and Warburg Pincus, Hillhouse Capital Group, Gopher Asset and Standard Chartered Private Equity, who invested in the Series A financing of the company in 2015, raised US$1.4 billion in its listing on the NYSE in October 2016, making it the largest IPO by a Chinese company in the United States in 2016, and, after Alibaba, the second-largest in history for US IPOs of Chinese companies.

Another noteworthy IPO was the IPO of Beijing Baofeng Technology Co, Ltd on the Shenzhen Stock Exchange in 2015, which became the first-ever listing of a Chinese internet company on China’s A-share market after phasing out its VIE structure, trailblazing a trend of Chinese technology companies tearing down VIE structures and seeking to be listed on Chinese or Hong Kong stock exchanges.

IV REGULATORY DEVELOPMENTS

i Promulgation of the FIL and its implementation rules
The FIL, as the new fundamental piece of legislation for the foreign investment legal system, became effective on 1 January 2020. In the past, the laws relating to foreign investment in China, including the Law on Wholly Foreign-Owned Enterprises (which applies to WFOEs), the Law on Sino-Foreign Equity Joint Ventures (which applies to EJVs), the Law on Sino-Foreign Cooperative Joint Ventures (which applies to CJVs) (collectively, the Old
FIE Laws), various regulations and foreign investment administrative systems under the Old FIE Laws had been constantly updated and adjusted to adapt to the new challenges of the times. With the new FIL becoming effective, the Old FIE Laws and the old administrative systems thereunder were officially repealed simultaneously. It is also conceivable that the implementation of the FIL, the FIL Implementation Regulation and other new rules and regulations will lead to large-scale adjustments and clean-up improvements of various regulations based on decades-old regulatory approaches.

The FIL provides the fundamental rules for the promotion, protection and administration of foreign investment. It clearly stipulates the principle that domestic and foreign investment will receive equal treatment (e.g., at the investment access stage, the treatment of foreign investors and their investments are not to be less favourable than those of domestic investors and their investments). The foreign investment is subject to pre-access national treatment and a negative list management system. The negative list approach is not new to the public as it was first introduced in China (Shanghai) Pilot Free Trade Zone (FTZ) in 2013; however, the FIL, which pre-empts local regulations, has established the negative list approach as a nationwide regime for all foreign investments in China.

In fact, the FIL has emphasised the promotion and protection of investment in special chapters, and among these chapters, the protection of intellectual property rights, the prohibition of compulsory technology transfers and the equal participation of foreign-invested enterprises in government procurement and in a standard setting are deemed as positive responses to recent public demands.

Another drastic change is that, under the FIL, FIEs in China are no longer categorised as WFOEs, EJVs and CJVs, and are instead equally subject to the provisions of the Companies Law, the Partnership Enterprise Law of PRC and other laws that are mainly applicable to domestic entities. Domestic enterprises and FIEs are established and operated in accordance with the unified rules. FIEs’ corporate governance structures, shareholder or board meeting and voting procedures, equity transfers and profit distribution will be fully compatible with those of domestic enterprises. As such, the parties involved with or related to the foreign-invested enterprises may design and implement various arrangements and practices more flexibly. In the past, some Old FIE Laws contained certain corporate governance rules applicable to FIEs that were different to those set out under the Companies Law. FIEs that have corporate governance structures designed pursuant to Old FIE Laws need to convert their governance structures and amend their articles of association accordingly. The FIL allows such FIEs to keep their existing governance structure for a five-year transitional period, but they are required to complete the change to comply with the FIL by 1 January 2025. If FIEs fail to make the change within the transitional period, SAMR will not process other registration matters for these companies.

On 12 December 2019, China’s State Council adopted the FIL Implementation Regulation, which took effect on 1 January 2020 together with the FIL. The FIL Implementation Regulation provides additional details and clarity on several general provisions and principles set out in the FIL. The FIL Implementation Regulation re-emphasises the national treatment principle for FIEs in several important areas, sets out FIEs’ rights to participate in rule-making, standards formulation and government procurement, and also provides further details regarding expropriation of foreign investors’ investments, protection of intellectual property, the new nationwide negative list system for administration of the establishment of and changes to FIEs, information reporting, and the transitioning of existing FIEs.
On 26 December 2019, the Supreme People’s Court of PRC issued the Interpretation on Certain Issues Regarding the Application of the Foreign Investment Law (Interpretation), which also took effect on 1 January 2020. The Interpretation provides guidance on questions relating to the effectiveness and enforceability of foreign investment-related agreements, such as shareholder agreements, share transfer agreements and project contracts that may arise under the new negative list system. According to the Interpretation, with respect to agreements for investments in sectors that are not restricted under the negative list, Chinese courts should reject claims that an agreement is void or invalid if the parties have not completed relevant registration and approval procedures. However, with respect to agreements for investments in sectors that are prohibited by the negative list and agreements that violate the restrictions set out in the negative list, Chinese courts should uphold claims that the agreement is invalid.

On 1 January 2020, two separate notices issued by MOFCOM took effect and repealed various regulations, notices and other ministerial documents that had governed FIEs and their administration. However, with the abolition of the Old FIE Laws, a large number of regulations and rules have also been abolished or amended. The FIL Implementation Regulation stipulates that the FIL and the FIL Implementation Regulation shall prevail in the case of any discrepancy between them and any other regulations or rules (related to foreign investment regulation) that were effective prior to 1 January 2020. While this establishes the principle for resolving potential discrepancies, there may still be problems in practice without proper housekeeping of existing foreign investment regulations and rules. For the time being, relevant authorities such as MOFCOM, NDRC and the Ministry of Justice are all in the process of cleaning up existing regulations and rules. We expect the housekeeping of the implementation rules of the Old FIE Laws and other relevant regulations and rules to be completed and disclosed to the public relatively soon.

Some questions left unanswered by the FIL and the new FIL Implementation Regulation still exist and further clarification and improvement by the legislators and regulators are required.

ii  Amendment to the Foreign Investment Catalogue

On 30 June 2019, NDRC and MOFCOM jointly issued the Foreign Investment Negative List (2019) (the 2019 Negative List), which took effect on 30 July 2019, and repealed, on the same date, the Foreign Investment Negative List (2018) (the 2018 Negative List). Prior to the issuance of the 2018 Negative List, foreign investment in China was subject to the Foreign Investment Catalogue (the latest edition was announced in 2017), which categorised industries as encouraged, permitted, restricted or prohibited for foreign investment. Similar to the 2018 Negative List, the 2019 Negative List only lists those industries subject to special management measures for foreign investment access, including 40 restricted and prohibited industries. Foreign investors in industries not listed in the Foreign Investment Negative List will be treated equally with Chinese investors in terms of market access. The 2019 Negative List reduces the number of industries restricted and prohibited for foreign investments from 48 (in the 2018 Negative List) to 40, further loosening restrictions on market access. The following are the key changes in some of the sectors that were the subject of particular focus: in the mining sector, a WFOE is now permitted to engage in the exploration and development of oil and natural gas in such business, which was previously open to EJVs and CJVs only; the prohibition against offshore investors investing in exploration and mining of molybdenum, tin, antimony and fluorite has been eliminated;
in the manufacturing sector, the prohibition against foreign investors investing in the production of Xuan paper and ink sticks has been eliminated;

c in the infrastructural facilities sector, the restriction that the construction and operation of gas, heating and water supply and drainage pipe networks for a city with a population of more than 500,000 must be controlled by Chinese parties has been eliminated;

d in the transportation and logistics sector, the restriction that domestic shipping agencies must be controlled by Chinese parties has been eliminated;

e in the cultural sector, the restriction that the construction and operation of cinemas and performance agencies must be controlled by Chinese parties has been eliminated;

f in the technology sector, the restriction on foreign investment in domestic multi-party communications, telecommunication storing-and-forwarding business and call centre businesses has been eliminated; and

g in the environmental and public facilities management sector, the prohibition against foreign investors investing in the development of wildlife and plant resources that are originated from and protected by China has been eliminated.

Similar to the 2018 Negative List, the 2019 Negative List also sets out a road map and timetable for the further opening up of the financial services and automobile sectors in the next few years. According to these provisions, all foreign shareholding restrictions in the financial services sector will be lifted by 2021; foreign shareholding restrictions on the manufacturing of commercial vehicles and passenger vehicles will be lifted by 2020 and 2022, respectively; and the current restriction on foreign investors establishing more than two joint ventures manufacturing the same category of whole-vehicle products will also be removed by 2022.

On 30 June 2019, NDRC and MOFCOM promulgated the Catalogue of Encouraged Industries, which came into effect on 30 July 2019, and consists of a list applicable to the entire country, and another list only applicable to China’s central, western and north-eastern regions and Hainan province. Compared with the list of the encouraged industries in the Foreign Investment Catalogue (2017 Edition) and the Foreign Investment Catalogue of the Priority Industries in Central and Western China (2017 Edition), the number of industries in which foreign investment is encouraged has been expanded. More than 80 per cent of the new additions and revisions of the nationwide list fall within the manufacturing sector, which supports and encourages foreign investment into high-end manufacturing, intelligent manufacturing, green manufacturing and relevant areas. The list applicable to central, western and north-eastern regions and Hainan province is more focused on labour-intensive industries and advanced and applied science industries, as well as the construction of supplementary facilities, encouraging foreign-invested businesses to move to those regions.

iii FIE information reporting system

Prior to 1 January 2020, FIEs needed to submit information through two channels: (1) the MOFCOM foreign investment record-filing system; and (2) the SAMR company registration system and enterprise credit information disclosure database. With the implementation of the FIL, these two channels have been unified. The scope and content of information required to be submitted by FIEs are limited to those deemed necessary by law and regulations.

To lay the groundwork for the administration of FIE establishment and changes, MOFCOM and SAMR issued the Foreign Investor Information Reporting Measures (the Reporting Measures) on 30 December 2019, and MOFCOM issued the Notice Regarding
Foreign Investor Information Reporting Related Matters (the Reporting Notice) on 31 December 2019, both of which took effect on 1 January 2020. Under the Reporting Measures and the Reporting Notice, MOFCOM's record-filing system has been replaced by an information reporting system that applies to FIEs, foreign invested partnerships, foreign enterprises engaging in operation and production in China, and representative offices of foreign enterprises covering information reporting with respect to the establishment of FIEs and their subsidiaries, changes to FIEs and their subsidiaries, and annual reporting. Further details regarding the new annual reporting system for FIEs are set out in the Notice on Completing Annual Reporting ‘Multiple Reports in One’ Reform Related Work issued by MOFCOM, SAMR and the State Administration of Foreign Exchange on 16 December 2019. Information already submitted to SAMR by FIEs will be shared with MOFCOM and does not need to be separately submitted again by FIEs or foreign investors in information reports.

iv  Pilot FTZs and the negative list market entry system

On 2 August 2019, the State Council released overall plans for launching six new FTZs in the provinces of Shandong, Jiangsu, Guangxi, Hebei, Yunnan and Heilongjiang, bringing the total to 18. These are located in Shanghai (2013), Guangdong, Tianjin and Fujian (2014), Henan, Hubei, Liaoning, Shaanxi, Sichuan, Chongqing and Zhejiang (2017), Hainan (2018) and Shandong, Jiangsu, Guangxi, Hebei, Yunnan and Heilongjiang (2019).

On 19 October 2015, the State Council issued the Opinion on the Implementation of the Negative List Market Entry System for the first time. The Opinion reflects the negative list approach that was first applied in China (Shanghai) Pilot FTZ, and that was later introduced to other pilot FTZs. With the enforcement of the FIL, the negative list approach has been adopted as a nationwide policy. However, the negative list that applies to the FTZs contains fewer restrictions than the nationwide list (which only applies to areas other than the FTZs).

On 30 June 2019, the State Council issued Special Administrative Measures (Negative List) on Foreign Investment Access to the Pilot Free Trade Zone (2019) (the 2019 FTZ Negative List), which is the sixth version of the FTZ Negative List and which took effect from 30 July 2019. The 2019 FTZ Negative List, which applies to the 18 pilot FTZs, from Shanghai to Yunnan, contains 37 restricted and prohibited sectors, and further opens up certain sectors that are still restricted or prohibited under the Foreign Investment Negative List applying to the territories outside the FTZs. The 2019 FTZ Negative List is a foreign investment list that sets out the foreign investment entry requirements for listed sectors not subject to national treatment with domestic investment in FTZs. Compared with its 2018 counterpart, the 2019 FTZ Negative List further deleted eight restrictive measures in several industries. The 2019 FTZ Negative List is slightly shorter than the Foreign Investment Negative List, and it is expected that the FTZ Negative List will continue to be the benchmark for future amendments of the nationwide Foreign Investment Negative List. In addition to the relaxation of foreign investment restrictions in the Foreign Investment Negative List as outlined above, the 2019 FTZ Negative List further relaxes the foreign investment restrictions in the following sectors as follows:

a  the prohibition against foreign investors from investing in fisheries in China's territorial and inland water has been eliminated; and

b  the restriction that the printing of publications must be controlled by Chinese parties has been eliminated.
China

v Outbound direct investment regulatory regime

The Chinese government promotes what it considers to be a healthy and sustainable development of outbound investments. Genuine and lawful outbound direct investment (ODI) deals continue to be supported, but the authorities on various levels have tightened the scrutiny of their authenticity and compliance in recent years. While genuine and lawful ODI transactions continue to be generally viable, delays in the outbound remittance of funds have increased. In addition, the regulators are closely monitoring certain types of restricted ODI deals, as set out above, and have reminded Chinese companies to make ‘prudent’ decisions. Under both ODI approval and filing procedures (see above in relation to NDRC approval and filing with MOFCOM), investors are required to provide a substantial amount of documentation and information to various authorities, and in both procedures the authorities have a certain degree of discretion in deciding whether to grant an approval or accept a filing. Chinese companies and their business partners should also keep in mind that material changes in an existing outbound investment shall be reported and may trigger another round of review by Chinese authorities.

V OUTLOOK

In light of increased scrutiny by regulators in both the United States and China, foreign private equity investors in China continue to increase their focus on rigorous pre-transaction anti-corruption due diligence, taking steps to ensure that any improper conduct has ceased prior to closing and implementing robust compliance policies after closing. In high-risk scenarios, such as transactions involving companies in which significant government interactions are necessary for their operations, the process can be complex and expensive.

Looking forward into 2020, we expect several key factors to impact the level of dealmaking activities for the year as compared to 2019. One key theme of the region going into 2020 is the extent to which the unpredictable trend of the US–China trade war and the political and economic uncertainties between the United States and China, combined with an increasingly tightened EU foreign investment-screening framework, will affect China’s economic growth in the upcoming year. Separately, on 31 January 2020, the World Health Organization declared the outbreak of coronavirus disease 2019 (COVID-19 virus), which initially emerged in Wuhan, China, in December 2019, as a global health emergency. The magnitude of the impact that the COVID-19 virus will have on China and globally is yet to be seen, but the outbreak will certainly create significant challenges to China’s overall economic performance in 2020.

The regulatory landscape is also a key factor that may impact investment patterns. In terms of the foreign investment regulatory regime, the newly promulgated FIL and the corresponding foreign investor-friendly regulatory regime may attract more active foreign investments in the local market. On the other hand, foreign exchange control policy and availability will continue to play a significant role in leveraging the competitiveness of Chinese investors’ participation in bidding for overseas assets, and will impact capital inflow and outflow. Separately, as China continues to broaden access to its market by foreign investors and improve the foreign investment environment, certain investors may find new opportunities in the reorganisation, consolidation and restructuring of SOEs, listed companies, financial institutions and top-notch start-up firms. However, other investors may shy away from dealmaking because of increased uncertainty in some traditional industries or over-leveraged sectors where the country’s regulators may look to curb excessive capital
inflow. Key industries such as information technology, healthcare, education and financial services are likely to become the driving forces from which significant transactions can be generated. Major technology companies such as Baidu, Alibaba and Tencent will continue to lead the way in industry, upgrading and consolidating given their active M&A appetite and the inherent need for sustainable growth. For certain industries or sectors in which national security, data protection or individual privacy is involved, the regulatory authorities may roll out new measures to ensure that appropriate protection mechanisms will be put into place. In other traditional sectors in which foreign investors’ majority ownership is permitted for the first time, such as securities firms, life insurance companies and financial asset management companies, private equity investors could find new investment targets or collaborative opportunities for major transactions.

Following the IPO boom in the Hong Kong Exchange, the Shanghai Stock Exchange and the Shenzhen Stock Exchange (especially the newly launched Sci-tech Innovation Board) in 2019, 2020 is expected to be a strong year for IPO exits in China’s domestic stock markets. While the Chinese domestic stock markets have provided more flexible channels for companies to list on the A-share market, the effects of this new registration-based regime remain to be assessed. Offshore banks and credit funds could try to maintain a meaningful role in financing M&A activities in the region in general, given the regulators’ overhaul of the outbound investment regime (including with respect to capital outflow). One increasingly common deal structure to note is the consortium formed by private equity funds together with strategic investors, especially public companies, in regional and international dealmaking. These are already playing major roles in a number of recently signed or closed transactions, such as the proposed US$6.4 billion acquisition of Amer Sports, in which an investor consortium consisting of FountainVest Partners, ANTA Sports Products Limited, an affiliate of Chip Wilson (founder of Lululemon Athletica Inc) and Tencent Holdings made a voluntary public tender offer for all the shares in Amer Sports Corporation. Not only do the private equity funds complement strategic investors’ industry knowledge with their expertise in valuation and deal execution, but they themselves also benefit from the readily available exit opportunity provided by their strategic partners; the prevalence of this consortium structure in the market is likely to further increase.

While going-private transactions involving Chinese companies listed in the United States have significantly slowed down, there have been quite a number of going-private transactions involving Chinese companies listed in the Hong Kong Stock Exchange and the Singapore Exchange, and there could be increased market attention in 2020 on going-privates or takeovers of Chinese companies listed on these capital markets. Two remarkable transactions heading the trend of Hong Kong-listed companies going private were Blackstone’s US$322.6 million takeover of property and construction group Tysan Holdings, which was launched in August 2013 and closed in January 2014, and Carlyle’s take-private of Asia Satellite Telecommunications Holdings Ltd, in which Carlyle agreed to buy out General Electric’s 74 per cent stake in the company for up to US$483 million, which was launched in December 2014 and closed in May 2015. In May 2016, Hong Kong-listed Wanda Commercial Properties’ controlling shareholder, Dalian Wanda Group, on behalf of the joint offerors, including Pohua JT Private Equity Fund LP, Ping An of China Securities and Shanghai Sailing Boda Kegang Business Consulting LLP, made an offer valued at US$4.4 billion for the going-private of Wanda Commercial Properties, as the largest going-private offer in the history of the Hong Kong Stock Exchange. The deal was completed and Wanda Commercial Properties was delisted from the Hong Kong Stock Exchange in September 2016. A highlight
of Chinese investors’ take-private of a Singapore-listed company was the purchase of the Singapore-listed Global Logistic Properties (GLP), the largest warehouse operator in Asia, at US$11.6 billion, by a Chinese private equity consortium led by Chinese private equity firm Hopu Investment Management, Hillhouse Capital Group, Chinese property developer Vanke Group and the Bank of China Group Investment, supported by GLP chief executive Ming Mei: the deal was completed in early 2018. Market participants also continue to monitor court decisions in the Cayman Islands regarding dissenting shareholders, and how such decisions may further shape both the merger regime in that jurisdiction, where many Chinese companies listed overseas are incorporated, and the broader going-private market.
Chapter 5

GERMANY

Volker Land, Holger Ebersberger and Robert Korndörfer

I OVERVIEW

i Deal activity

The German private equity (PE) market began 2019 as it left 2018 (slowly) but gained traction in the second half of the year. Looking at the aggregated numbers for 2019, the deal activity (buyouts) remained on a high level in terms of number of deals (219 deals), although this was a slight decrease compared with 2018 (229 deals). However, the 2019 total buyout volume of €32.2 billion, the highest level since the financial crisis, was mainly driven by six large-cap transactions in the second half of 2019.² Whereas the number of exits remained constant (44 exits in each half of the year), the volume of exits more than doubled in the second half of 2019 compared with the first half. Nonetheless, the number and volume of exits did not come close to reaching the levels of previous years. One PE-backed initial public offering (IPO) took place in 2019.³


<table>
<thead>
<tr>
<th></th>
<th>2019 total</th>
<th>Half-year 1 (HY1) 2019</th>
<th>Half-year 2 (HY2) 2019</th>
<th>Growth from HY1 to HY2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total buyouts (billions of euros)*†</td>
<td>32.2</td>
<td>7.3</td>
<td>24.9</td>
<td>+341.1%</td>
</tr>
<tr>
<td>Total exits* (billions of euros)†</td>
<td>10</td>
<td>2.6</td>
<td>7.4</td>
<td>+284.62%</td>
</tr>
</tbody>
</table>

* See footnote 2; †rounded numbers.

Large-cap companies continue to be of particular interest, especially for non-German PE investors. In 2019, eight PE transactions exceeded the €1 billion threshold, reaching an aggregate value of €21.9 billion.⁴ Nevertheless, small and mid-cap companies continue to constitute the predominant part of the deal activity of PE investors in Germany.

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1 Volker Land and Holger Ebersberger are partners and Robert Korndörfer is an associated partner at Noerr LLP.
2 EY, Private Equity Transaktionsmarkt in Deutschland, Gesamtjahr 2019.
3 id., IPO of Teamviewer backed by Permira.
4 See footnote 2.
Germany

**PE buyouts**

**General development**

In 2019, the aggregate buyout value for PE transactions reached €32.2 billion.⁵ Compared with 2017, in which a value of €19.4 billion was reached,⁶ this is an increase of approximately 166 per cent. The number of buyouts did, however, slightly decrease from 227 in 2017 and 229 in 2018 to 219 in 2019.⁷

<table>
<thead>
<tr>
<th>Total buyouts by value (billions of euros)</th>
<th>2007*</th>
<th>2017†</th>
<th>2018†</th>
<th>2019†</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>22.7</td>
<td>19.4</td>
<td>17.9</td>
<td>32.2</td>
</tr>
</tbody>
</table>

* Mergermarket; †See footnote 2.

**Severe competition**

Germany remains an attractive market for PE investors, and in 2019, PE transactions continued to be an important driver of the overall M&A activity in the market. With an aggregate PE deal activity of €32.2 billion in 2019, PE deals contributed a little less than 45 per cent of the aggregate M&A deal activity of €72.9 billion in 2019.⁸ Although this is still significantly more compared with 2017, in which PE transactions contributed approximately 30 per cent to the aggregate M&A activity, it more or less reflects the same percentage as in 2018. However, the aggregate M&A activity increased by more than 70 per cent compared with 2018. This shows that the strong competition between strategic investors and financial sponsors for targets in Germany is continuing, whereas the trend of previous years, in which PE investors steadily increased their share in German M&A activity, has slowed down. This might also be a result of strategic investors being willing, to a certain extent, to offer higher prices as they can benefit from synergies resulting from an acquisition.⁹

**Large cap versus small and medium cap**

With an aggregate value of €21.9 billion, around two-thirds of the overall buyout value can be attributed to eight large-cap transactions in Germany,¹⁰ the largest being the acquisition of Currenta by funds managed by Macquarie Infrastructure and Real Assets (MIRA) (€3.5 billion), followed by the acquisition of BASF (construction chemicals) by Lone Star for €3.2 billion¹¹ and the acquisition of Evonik Industries AG’s Methacrylates business by Advent managed funds for €3 billion.¹²

The majority of overall deal activity was made up of small and medium-cap transactions with an aggregate value of approximately €10.3 billion.¹³ Whereas this only reflects the transactions that are disclosed, the actual value will be significantly higher, as small and mid-cap focused PE investors, in particular, tend to keep acquisition value secret.

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⁵ ibid.
⁶ ibid.
⁷ ibid.
⁸ ibid.
¹⁰ See footnote 2.
¹¹ Handelsblatt, 14 January 2020.
¹² See footnote 2.
¹³ ibid.
Industries

In terms of industries, the highest transaction value was achieved in the chemicals sector (€6.8 billion), which was mainly driven by the acquisition of BASF (construction chemicals) by Lone Star for €3.2 billion and the acquisition of Evonik Industries AG’s Methacrylates business by Advent for €3 billion. The chemicals sector is followed by information technology (€5.7 billion), media (€5.1 billion), industrial (€4.6 billion) and other services (€4.6 billion). In 2017, the top two industries that attracted PE investors were pharma and healthcare (€6.7 billion) and chemicals (€2.9 billion).

In terms of number of deals, the information technology sector attracted the most financial sponsors, with 49 transactions in 2019. Although this sector also had the highest number of deals in 2018, with 30 transactions, this increased significantly in 2019, by approximately 63 per cent. The information technology sector is followed by the industrial (42 transactions), media (13), other services (12) and chemicals (9) sectors.

The above figures show that digitalisation is an important driver of M&A activity in the German market. The media sector, which has been of lower interest in past years, is now being perceived as an interesting market. A prominent example is the formation of the German media group Leonine by KKR through several acquisitions in the German market, including Tele München Group, Universum Film, i&u TV and Wiedemann & Berg Film.

Exits (other than IPOs)

In 2019, the number of exits significantly decreased to the lowest level since 2015. The aggregate deal value even decreased to the lowest number since 2012. Out of 87 exits (without IPOs) in 2019, in 48 cases strategic investors acted as buyers and 39 secondary buyouts took place. Although the ratio between strategic and secondary buyouts remained more or less the same as in 2018, the aggregate number of exits decreased significantly from 113 in 2017 and 115 in 2018 to 87 in 2019. This is a decrease of approximately 25 per cent. Nevertheless, secondary buyouts constitute an important exit option in the German market. A prominent example is Bike24, which Bridgepoint’s Wiggle CRC acquired in 2017 from Riverside and sold back to Riverside in September 2019.

<table>
<thead>
<tr>
<th></th>
<th>2007*</th>
<th>2017†</th>
<th>2018†</th>
<th>2019†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales to strategic investors (value in billions of euros, and number)</td>
<td>16.8</td>
<td>8.2 (60)</td>
<td>4.5 (66)</td>
<td>3.3 (48)</td>
</tr>
<tr>
<td>Secondary buyouts (value in billions of euros, and number)</td>
<td>14.8</td>
<td>7.4 (53)</td>
<td>9.9 (49)</td>
<td>4.6 (39)</td>
</tr>
<tr>
<td>Total</td>
<td>31.6</td>
<td>15.6</td>
<td>14.4</td>
<td>7.9</td>
</tr>
</tbody>
</table>

* Mergermarket; †See footnote 2.

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14 ibid.
15 ibid.
16 ibid.
17 ibid.
18 ibid.
ii Operation of the market

Sales process

As in previous years, in 2019, a large number of transactions were structured as bidding contests, in many cases including a dual-track process such as in the sale of Deutsche Bahn's foreign transportation business (DB Arriva), which was initiated in 2019 with the aim of Deutsche Bahn collecting €2 billion to €3 billion.

The actual numbers show that IPOs rather constitute the exception in Germany (see above). The vast majority of sales processes ultimately resulted in private sale transactions. The sales process around DB Arriva might become a prominent exception in 2020. Shortly after Deutsche Bahn entered into reportedly exclusive talks with Carlyle, the process was stopped in November 2019 and Deutsche Bahn announced on 4 December 2019 that it was in the process of preparing a listing of DB Arriva, which is likely to take place in 2020.19

One-on-one transactions are still the exception, which again shows that the market remains seller-friendly. With vast amounts of dry powder in the market20 and continuous low interest rates, the race for targets continues to be challenging. Time is of the essence in competitive sales processes and PE investors are having to find the balance between a diligent assessment of the targets, limited information in due diligence processes (in particular, in Q&A processes) and the appropriate level of opportunity costs. At the same time, the level of multiples achieved in the market remains high. Depending on the relevant industry, two-digit multiples continue to be unexceptional. In particular, software-based business models are highly competed for and achieve, in general, multiples above average. On a global level, earnings before interest, taxes, depreciation and amortisation (EBITDA) multiples in the technology sector reached an averaged level of 15.5 compared with 13.3 in 2018.21 However, this is, of course, not applicable to all industries. In other industry sectors, the level of EBITDA multiples on a global level even showed a slight decrease compared with 2018.22

Warranty and indemnity insurance

In 2019, warranty and indemnity (W&I) insurances continued to be standard for a large number of processes, particularly in structured large and mid-cap sales processes. In this segment, uninsured deals have become the exception. Particularly on structured sales processes, bidders are generally asked to go with buy-side W&I insurance. A large proportion of sales processes entailed stapled W&I insurance, where the sell side introduces the W&I insurance to the deal. Once the preferred bidders are selected, the W&I process is flipped over to the buy side. Depending on its level of sophistication, the sales process can be structured as either a 'soft' or a 'hard' stapling. Many processes are structured as 'soft' stapling. In a soft stapling, the sell side will only obtain non-binding indications from insurers via its chosen broker based on the initial draft transaction documents, an information memorandum and the financial statements of the target. The ultimate negotiations will be conducted by the buy side after the flip over on the basis of the buy side's due diligence reports. In a hard stapling, the sell side

21 id., at p. 11.
22 ibid.
also provides vendor due diligence reports to the insurers and initiates negotiations with the insurers. The draft policy is already provided to the buy side and finalised after the flip over to the buy side. In such cases, the buy side usually also provides top-up due diligence reports.

In structured sales processes, bidders are often asked to cover the potential exposure for operational warranties as well as unknown tax risks exclusively via the W&I insurance policy without any recourse to the seller. In addition, separate title insurances have been seen in the market.

Management equity incentive schemes

For PE investors, the implementation of management incentive schemes is one of the most effective tools to ensure the commitment of the management of the acquired target. There is a broad set of structures used in the market depending on the sophistication of the relevant investors and on the level of the management to be incentivised. While senior management members are often granted straight equity structures, to incentivise mid-level management stock appreciation rights, virtual shares and profit participations, among other things, are relatively popular as they are easy to implement and flexible.

The main goal when structuring management incentive schemes from a tax perspective is to get into a capital gains taxation category (up to 28 per cent taxation plus church tax) rather than a taxation as income category (up to 48 per cent plus church tax). Therefore, straight equity participations are often considered to be more tax efficient for management than stock options, virtual participations, etc. Tax authorities tend to qualify income from management participations as ordinary income, particularly if they have a strong link to the employment or service agreements (leaver clauses), and if the conditions are more favourable than those applicable to the other investors or shareholders. Structuring equity-based incentive schemes also aims at avoiding dry income of the relevant manager, which might be subject to the German income tax regime.

Equity-based incentives often range from 5 to 15 per cent of the issued share capital, taking into account equity-like instruments or shareholder loans. The economic ownership percentage is often significantly lower (e.g., 1 to 5 per cent). The relevant percentages are higher in small and lower mid-cap targets (particularly in the case of the acquisition of owner-managed targets in which the sellers roll over a certain part of their shares against issuance of new shares at the level of the investor). In large-cap transactions, the percentages are usually significantly lower, particularly if the management is asked to invest its own cash to ensure 'skin in the game'. The customary range of such a cash investment would extend to an amount equal to between one and one and a half times a fixed annual salary.

In connection with equity-based incentive schemes, shareholders’ agreements usually mainly aim at securing flexibility for the PE investor, in particular with respect to capitalisation (e.g., as regards recapitalisation measures) and exit strategies. This often entails customary agreements on drag-along rights for the investors and cooperation obligations for management in exit situations, as well as holding periods post exit (in IPO scenarios).

The management, on the other hand, is generally granted a limited set of shareholders’ rights, such as tag-along rights in exit scenarios or subscription rights in the case of capital measures. The deal for the management is often sweetened commercially by arrangements such as equity kickers, sweet equity or agreed floors for a guaranteed return.
**Earn-out structures**

In 2019, the market experienced a certain renaissance of earn-out structures (i.e., structures in which the consideration payable to a seller is contingent upon the future performance of the target business or based on the achievement of certain milestones). In particular, in the high-priced German market, earn-out structures can bridge different views of the parties on the valuation of the target. On one hand, sellers gain the option to achieve a potentially higher purchase price and – in buy-and-build approaches – have the opportunity to use synergies of the existing business of the target and purchaser, to achieve the agreed milestones. On the other hand, purchasers reduce the risk of overpaying or even gain additional finance options.

However, despite the advantages that earn-out structures might bring, the details often require particular focus. The involved parties are well-advised to carefully and clearly stipulate in binding agreements the relevant earn-out triggers as well as the mutual rights and obligations of the parties relating thereto. Whereas from a seller’s perspective earn-out protection arrangements (e.g., review rights, security for outstanding earn-out payments, premature payment in change-of-control scenarios) will become important, purchasers will want to make sure to remain flexible and to avoid setting the wrong incentives with the result that short-term goals during the earn-out period beat long-term goals of the business.

## II LEGAL FRAMEWORK

### i Acquisition of control and minority interests

The legal framework for the acquisition of control and minority interest has not changed materially over recent years and is – apart from certain notarisation requirements under German law, the formalities of which are often accompanied by the raising of eyebrows by foreign investors entering the German market for the first time – in line with what can be expected from a highly sophisticated legal environment. The acquisition of shares is the most common structure, whereas asset deal structures are in most instances the means of choice in distressed scenarios. However, in particular in carve-out scenarios in larger corporate groups, mixed share and asset deal structures were seen in 2019.

The acquisition of a target by a PE investor is often structured as leveraged buyout (LBO) and therefore financed partly by equity and debt. The PE investor typically acquires the target via a special purpose vehicle (SPV) that is held indirectly by the investing funds. In an acquisition structure aiming to acquire a German target, the most common legal form for the acquiring SPV (AcquiCo) is a German limited liability company (GmbH). In a typical LBO, the debt is taken up by the AcquiCo. Often, after closing, either the AcquiCo is merged with the target by way of an upstream merger or a fiscal unity is established between the AcquiCo and the target by way of a profit-and-loss pooling agreement. This optimises the tax structure and eases the repayment of the LBO debt out of the free cash flow of the target.

Equity-based incentive schemes (see Section I) are typically not implemented at the level of the AcquiCo but on a level higher up in the corporate structure.

### ii Fiduciary duties and liabilities

The canon of fiduciary duties and liabilities is often stipulated in detail in shareholders’ agreements, and is closely negotiated. This applies in particular to buyouts of owner-managed businesses in which the seller remains invested with a substantial stake. PE investors will generally not be involved in the day-to-day operations of their portfolio companies (e.g., by appointing portfolio managers as managing directors), but will rather influence the strategic
decisions of the portfolio companies and provide industry know-how through seats on supervisory bodies. The specific legal framework generally depends on the legal form of the portfolio company and the investing entity. Most common are GmbH structures in which the parties are relatively flexible and can agree on a comprehensive regime of rights and duties of the investor. However, certain general statutory shareholders’ duties have to be observed and cannot be derogated.

Capital maintenance
The PE investor has to observe the statutory capital maintenance rules stipulated in Sections 30, 31 and 43 of the German Limited Liability Companies Act (GmbHG) as regards GmbHs and Section 57 of the German Stock Corporation Act for German stock corporations. These provisions stipulate the general principle that the share capital (and, as regards stock corporations, any equity) may not be redistributed to the shareholders (whether openly or covertly). A breach of this principle can lead to repayment claims against the recipient and even personal liability of the management.

In particular, in LBO scenarios in which upstream guarantees and security are requested from the debt providers to guarantee and secure the loans granted to the acquisition vehicle, the capital maintenance rules have to be observed. Upstream guarantees and security can constitute a redistribution of the share capital, in the event that they are not covered by an adequate compensation claim against the borrower at the time of the issuance of the security.23 Also, the management of the securing company remains obliged to supervise the development of the adequacy of the compensation claim after the guarantees and security have been issued. In cases of an increased risk regarding the adequacy of the compensation claim, the management is obliged to request security or indemnification to avoid personal liability pursuant to Section 43 GmbHG. Several aspects and nuances of the requirements for fulfilling this obligation are disputed. In practice, the finance documents will generally contain certain limitation language to limit the personal liability of the relevant management.

German Capital Investment Code
The German Capital Investment Code (KAGB), which implements the Alternative Investment Fund Managers Directive24 into German law, provides for regulatory restrictions regarding distributions to PE investors. Pursuant to Paragraph 292, Section 1 KAGB, distributions, capital reductions, share redemptions or acquisitions of treasury shares are restricted within the first 24 months of control having been obtained over a non-listed company by alternative investment funds. Specifically, distributions that are made to shareholders are prohibited (1) if the net assets according to the annual financial statements fall below the amount of the subscribed capital plus non-distributable reserves, or would fall below that amount as a result of such a distribution (Paragraph 292, Section 2, No. 1 KAGB), and (2) if the amount of the distribution would exceed the amount of the result of the past financial year (plus profit carried forward and withdrawals from available reserves, less losses carried forward and legal and statutory reserves) (Paragraph 292, Section 2, No. 2 KAGB). Similarly, pursuant to Paragraph 292, Section 2, No. 3 KAGB, repurchases of treasury shares by or for the account of the company that result in the net assets falling below the threshold specified

23 German Federal Court of Justice, NZG 2017, p. 344.
pursuant to Paragraph 292, Section 2, No. 1 KAGB are prohibited. Paragraph 292 KAGB does not apply to small or medium-sized target companies (i.e., companies that have fewer than 250 employees, a yearly turnover below €50 million, where the balance sheet total is below €43 million or where the target company is a real estate SPV (Section 287, Paragraph 2 KAGB; Section 2 of the annex to Recommendation 2003/361/EC)).

**General fiduciary duties**

Shareholders in a German GmbH are subject to a general duty of loyalty towards the portfolio company. The extent of this fiduciary duty depends on the circumstances of the individual case. In principle, shareholders may not induce the company to conduct business that is detrimental to the company or its business if they exert influence on management decisions. The general duty of loyalty may also include a non-competition and confidentiality obligation for the shareholders.

### III YEAR IN REVIEW

#### i Recent deal activity

Germany continued to be an attractive market for PE investors in 2019. Although the overall number of buyout transactions slightly decreased compared with the totals in 2017 and 2018, the aggregate disclosed value of buyout transactions reached the highest level since the financial crisis (see Section I).

#### ii Key terms of recent control transactions

**Sale of Currenta to MIRA for €3.5 billion**

Bayer and LANXESS sold their stakes in the chemical park operator Currenta to funds managed by MIRA, the world’s largest infrastructure investor. Currenta manages and operates infrastructure, energy supply and other essential services across chemical parks in Leverkusen, Dormagen and Krefeld-Uerdingen and was a joint venture of Bayer (60 per cent) and LANXESS (40 per cent). Currenta, including a transferred real estate portfolio by Bayer, has a total enterprise value of €3.5 billion before deduction of net debt and pension obligations.

**Sale of BASF to Lone Star for €3.2 billion**

An affiliate of private equity group Lone Star has agreed to buy BASF’s construction chemicals business for €3.17 billion on a cash and debt-free basis. The acquisition is expected to close in the third quarter of 2020, subject to antitrust approval.²⁶

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Sale of Evonik Industries AG’s Methacrylates business to Advent for €3 billion

In March 2019, Evonik signed an agreement to sell its Methacrylates business to Advent International for €3 billion. The enterprise value was eight and a half times the business’s EBITDA.\(^{27}\) The transaction was closed in August 2019.\(^ {28}\) The Methacrylates business has 18 production sites and 3,900 employees worldwide.\(^ {29}\)

IV REGULATORY DEVELOPMENTS

i Merger clearance

PE transactions are often subject to merger control clearance either under the regime of the German Act against Restraints of Competition or under the EU Merger Regulation, if the relevant requirements are fulfilled.

On 9 June 2017, the amendments to the German Act against Restraints of Competition (ninth amendment of the Competition Act) entered into force, tightening the legal requirements for merger clearance. Prior to these amendments, the Competition Act required, inter alia, that (1) the participating companies to a transaction had total worldwide revenues of more than €500 million in the most recently completed fiscal year; (2) at least two companies had domestic revenues of which one company’s exceeded €25 million; and (3) another company had domestic revenues of more than €5 million (second domestic threshold).

To date, these thresholds have not been particularly successful in catching transactions with (target) companies that have rather small revenues but strong innovation potential, network effects and high purchase prices (especially start-ups and digital companies). One example is Facebook’s acquisition of WhatsApp, which was not subject to a notification requirement in Germany although the purchase price amounted to US$19 billion.\(^ {30}\) Since 9 June 2017, an additional threshold based on the transaction value has been in effect. According to this threshold, a transaction must also be notified if (1) the above-mentioned thresholds are reached (except for the second domestic threshold), (2) the value of the consideration for the merger is more than €400 million, and (3) the company to be acquired operates domestically to a significant extent.

The term ‘consideration’ includes all assets and other monetary consideration (purchase price) as well as liabilities that the acquirer takes over. According to the legislative materials for the new Competition Act, the term ‘consideration’ is to be interpreted broadly. It includes any consideration that is contingent on subsequent fulfilment of certain conditions (earn-out clauses). In addition, depending on the particular case, reinvestments of acquiring parties granted at a discount (sweet equity) may also have to be considered.\(^ {31}\)


\(^{29}\) ibid.


\(^{31}\) ibid.
Foreign investment

The European Union has adopted a framework regulation for the screening of foreign direct investments into the Union. The Regulation entered into force on 11 April 2019, although it will not apply until 11 October 2020. Unusually for an EU regulation, it merely provides a legal framework to be completed by the Member States. The decision on whether to set up a screening mechanism or to screen a particular foreign direct investment is to remain the sole responsibility of each Member State. The Regulation essentially contains four elements that are important for the control of direct investment from third countries.

First, the Regulation contains primarily constitutional requirements for the structure of the screening mechanism for direct investment from third countries for reasons of security or public order (transparency, setting a time frame for checks, confidentiality of information and opportunity for legal protection). The Regulation lists the factors that may be taken into account by the Member States or the European Commission in the screening process. These essentially match the criteria to be observed within the German foreign direct investment screening procedure under Germany’s Foreign Trade Regulation. Interestingly, industry and labour market policies have not been included, unlike initially discussed.

Second, the Regulation provides for an annual report to the European Commission by Member States on foreign direct investment in their territory. Member States are also required to report on the application of their screening mechanisms. This obligation could certainly have a disciplinary effect.

Third, the Regulation contains a framework for a cooperation mechanism between Member States and the European Commission. The Regulation provides that the European Commission or other Member States may make comments or submit opinions to which the Member State undertaking the screening ‘shall give due consideration’. This gives the European Commission and the other Member States (only) a somewhat proactive right to provide comments. The Regulation provides for certain deadlines for the cooperation mechanism. These deadlines will certainly have repercussions on the timing in practice.

As the fourth essential element, the Regulation contains requirements for projects or programmes of Union interest listed in the Annex to the Regulation (for example, the European global navigation satellite systems programmes). In this case, the European Commission has a right to comment.

The Regulation is expected to have at least two effects on the practice of controlling foreign direct investments. First, the obligation to disclose information on planned or already implemented investments – in particular in the case of Article 6 (i.e., foreign direct investment undergoing screening) – to the European Commission and all other Member States significantly increases the risk of disclosure of trade and company secrets. This applies in particular if an investment concerns key industries in another Member State. Second, the cooperation mechanism envisaged will most likely lead to investment screening taking longer in future than it does today. In particular, it will no longer be easily possible for the competent national authorities to take account of the time limit of the closing condition, which is often provided for in acquisition agreements, or of a longstop date according to which a clearance certificate must be available within a certain period. This must be taken into account in future when drafting appropriate clauses.

iii DAC6

Similar to most other EU Member States, Germany has already implemented Council Directive (EU) 2018/822 of 25 May 2018 (DAC6) into domestic law. The new Law will create reporting obligations for certain cross-border tax arrangements. Taxpayers and ‘intermediaries’, such as private equity funds, investment bankers and other advisers, will be obliged to report on a broad scheme of tax arrangements that goes far beyond ‘aggressive tax planning’. In principle, the reporting obligations will become effective on 1 July 2020 but DAC6 also covers arrangements that were implemented on 25 June 2018 (the latter to be reported by 31 August 2020). Dealmakers are well-advised to start preparing for the new administrative burdens to come. In addition, it might be advisable in certain situations to agree on mutual reporting obligations between the parties (e.g., in share purchase agreements or in side letters).

V OUTLOOK

Private equity investment will continue to play an important role in Germany in 2020. The vast amount of dry powder in the market and low interest rates force private equity investors to seek attractive targets. Although largely considered to be a high-price environment, Germany remains an attractive market. The political environment will remain challenging. With Brexit having taken place on 31 January 2020 and the upcoming presidential elections in the United States in November 2020, the first year of the new decade might have some obstacles in store for market participants. In addition, the increased tensions with Iran and the trade disputes between the United States and the European Union might entail further challenges. The German industry is in the middle of a transition phase, not only due to the ‘Fridays for Future’ movement, which will create challenges but also opportunities. The German market will probably see an increase of distressed transactions in various industry sectors, with the insolvency of Thomas Cook being the most prominent example so far. In particular, investors focused on restructuring scenarios might have a busy year ahead in 2020.
Chapter 6

INDIA

Raghubir Menon and Taranjeet Singh

I OVERVIEW

After a record-breaking 2018, global geopolitical tensions, trade wars, a rise in crude oil prices, general elections in India, public market woes, a sluggish capital market, liquidity crisis, slowing consumption growth in core sectors and stress in the banking and lending space made 2019 a challenging year for investments in India. Where all previous records were surpassed in 2018 with deal activity in India crossing the US$120 billion mark, deal activity slipped back to more normal levels in 2019 with deals worth US$73 billion. One of the key reasons for the slide was lack of big-ticket billion-dollar bets. However, despite the challenges, 2019 was the second-best year for deal activity in India, surpassing years prior to 2018.

2019 saw a watershed divide in the contours of dealmaking in India, with private equity (PE) and venture capital (VC) funding showing an increase compared to 2018 and mergers and acquisitions (M&A) activity showing a major decline. According to provisional data from VCCEdge, the M&A space recorded deals worth US$34 billion in 2019, dropping from an all-time high of US$82 billion in 2018. However, the total value would have been higher had a US$15 billion deal been completed between Reliance Industries Limited and Saudi Aramco. On the other hand, PE dealmaking carried its buoyancy from 2018 into 2019 and saw investments worth US$37 billion across 861 deals.

Sustained business reforms over the past several years have helped India in further improving its ranking by 14 points to reach 63rd position in the World Bank’s ‘Doing Business 2020’ report. Further, India earned a place among the world’s top 10 improvers for the third consecutive year. The government continued the trend of long-due legal and policy reforms in 2019. In September 2019, to spur economic growth, attract foreign investment, encourage job creation and support the domestic manufacturing sector, the government announced the single largest reduction in India’s tax rate in almost three decades.

1 Raghubir Menon is a partner and Taranjeet Singh is a principal associate at Shardul Amarchand Mangaldas & Co.
4 ibid.
7 See footnote 5.
Despite the challenges faced by the Indian economy in 2019, the investor community is still looking at India positively and deriving strength from policy decision-making that is targeted at either cleaning up the economy or making it easier to do business.

i  Deal activity

**General dealmaking trends in India in 2019**

With fewer billion-dollar mega deals, slowing consumption growth, a cautious approach of investors and distress in the banking and financial sectors led to a decline in overall deal activity in India in 2019. However, despite these factors, India appears to be resilient and has demonstrated signs of a stable deals landscape.\(^\text{10}\)

Similar to 2018, consolidation and deleveraging, the race for dominance in industry, interest from very deep-pocketed long-term institutional investors, sovereign wealth funds (SWFs) and strategic buyers who have placed significant bets on India’s growth story, and the availability of high-quality assets on the block, continued to act as key drivers for dealmaking in India in 2019. Consolidation to strengthen market position remained the primary trigger, driven by financial deleveraging, monetising non-core assets, entering new geographies and the faster pace of insolvency proceedings.

In terms of sectors, the technology sector continued to attract investors and there was an increased interest in the infrastructure sector.\(^\text{11}\) Due to the introduction of the amended Insolvency and Bankruptcy Code and the continuing banking sector and non-banking financial company (NBFC) crisis, the Indian stressed assets market continued to present prime assets at attractive valuations across a number of core areas for PE investors, SWFs and strategic buyers with an appetite for control deals, co-investment deals and platform deals.\(^\text{12}\)

Buyouts remained on an upward trajectory due to increase in investor appetite for control deals. The success story of the Blackstone-backed first real estate investment trust (REIT)\(^\text{13}\) in India, Embassy Office Parks REIT, paved the way for investors to access a new source of capital in the country. Platform deals based on the build-and-buy approach of funds to channel their expertise into specific sectors or focus areas continued as one of the key themes of dealmaking in 2019. PE funds such as Warburg Pincus, Goldman Sachs, Everstone, Blackstone and KKR, along with SWFs such as GIC, CPPIB, the Abu Dhabi Investment Authority and the Qatar Investment Authority, continued to demonstrate appetite for creating new platforms.

2019 saw global PE and M&A investors continuing to gravitate towards India and the investment values continued to surge.

**M&A dealmaking in India**

The M&A space saw a major decline and, as per provisional data from VCCEdge, M&A dealmaking activity recorded deals worth US$34 billion from an all-time high of US$82 billion in 2018.\(^\text{14}\) Further, 2019 saw a sharp decline in billion-dollar-plus mega deals and the number of such big-ticket deals fell to only five compared to 19 in 2018.

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\(^{10}\) See footnote 3.

\(^{11}\) See footnote 2.


\(^{13}\) An investment vehicle that owns and operates real estate-related assets and allows individual investors to earn income produced through ownership of commercial real estate without actually having to buy any assets.

\(^{14}\) See footnote 6.
Sectoral spread for M&A investments in 2019 also narrowed compared with 2018, with top deals ranging across materials (metal and mining), finance, industrials and technology compared with the internet, telecoms, petrochemicals, metals, renewable energy, IT, consumer goods and engineering sectors in 2018.\textsuperscript{15} The top six M&A deals struck during 2019 were as follows.\textsuperscript{16}

<table>
<thead>
<tr>
<th>Target</th>
<th>Buyer</th>
<th>Deal type</th>
<th>Deal value (US$ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Essar Steel</td>
<td>ArcelorMittal, Nippon Steel</td>
<td>Inbound</td>
<td>5.97</td>
</tr>
<tr>
<td>Gruh Finance</td>
<td>Bandhan Bank</td>
<td>Domestic (merger)</td>
<td>3</td>
</tr>
<tr>
<td>Bhushan Power &amp; Steel</td>
<td>JSW Steel</td>
<td>Domestic (deal yet to be completed)</td>
<td>2.73</td>
</tr>
<tr>
<td>Adani Gas Ltd</td>
<td>Total Holding SAS</td>
<td>Inbound</td>
<td>1.5</td>
</tr>
<tr>
<td>Mindtree</td>
<td>Larsen &amp; Toubro</td>
<td>Domestic</td>
<td>1.4</td>
</tr>
<tr>
<td>Sadbhav Infrastructure Road Projects</td>
<td>IndInfravit Trust</td>
<td>Domestic (deal backed by CPPIB)</td>
<td>0.96</td>
</tr>
</tbody>
</table>

In addition, another mega deal, the merger of Indiabulls Housing Finance Limited with Lakshmi Vilas Bank Ltd for US$4.1 billion, was not completed due to the Reserve Bank of India (RBI) not granting permission.

However, the total value would have been higher had a US$15 billion deal between Reliance Industries Limited and Saudi Aramco been completed, which has not happened yet due to lack of government permissions. Domestic buyers and sellers continued to dominate the M&A dealmaking space, accounting for more than half of the deals. Inbound deals remained flat in 2019 and saw total value plunge to US$12 billion from US$22.5 billion in 2018. Overseas acquisitions by Indian companies also declined by half to nearly US$2 billion in 2019.\textsuperscript{17}

PE dealmaking in India

2019 saw record PE dealmaking activity in India with investments worth US$37 billion across 861 deals.\textsuperscript{18} Consolidation to achieve size, scalability, new product portfolios and better operating models catapulted deal activity upward in the PE space, accounting for around nearly 50 per cent of total deal value in India in 2019.

The downward trend in deal volume continued in 2019; however, deal values surged upward in 2019 indicating an increase in the average ticket size. PE dealmaking saw a minor decline from seven big-ticket deals in 2018 to five in 2019.

2019 continued to report an increase in buyout deals, showcasing willingness on the part of investors to acquire greater control, and a paradigm shift in the thought process of promoters, who are proving open to ceding control over operational aspects in an effort to boost growth. Control became a key element in most transactions on account of concerns around transparency and governance-related issues. Control transactions eliminated trust deficit among investors and provided them with better control over operational and

\textsuperscript{15} ibid.
\textsuperscript{16} ibid.
\textsuperscript{17} ibid.
\textsuperscript{18} See footnote 5.
governance issues and the ability to maximise returns. Buyout activities broke all records in 2019 and surpassed 2018 by 30 per cent in value. Consolidation, secondaries and deleveraging also contributed towards buyouts and remain key drivers for PE activity.19

**PE investments in 2019 by stage**

As per a PricewaterhouseCoopers (PwC) report, buyouts and control deals were the major contributors to PE dealmaking in India and accounted for 35 per cent of total PE deals, followed by late-stage investments, which accounted for 26 per cent, growth stage investment, which accounted for 23 per cent, public investment in private equity (PIPE) deals, which accounted for 9 per cent, and early and other deals, which accounted for 7 per cent. Keeping up with the trend of 2018, buyouts and control deals remained the mantra of PE investors in 2019.20

**Exits**

Compared with 2018, 2019 saw a sharp decline in PE exits in terms of value and volume, recording 185 exits worth a little over US$9.5 billion. This was a 63 per cent decline in terms of value compared with 2018. As per the PwC report, public market sales accounted for the largest share of the exit value in 2019, up 45 per cent compared with 2018.21

**Indian investment market debuts**

In addition to record investment in the start-up sector, 2019 also saw debuts by the following international investors in India (mostly making bets on the Indian start-up ecosystem):

*a* Danone Manifesto Ventures, the venture investment arm of Danone Manifesto located in New York and Paris made its debut in India in 2019 with investments in the Mumbai-based fresh fast-moving consumer goods products company Drums Food International;

*b* private equity firm Apis Partners entered the Indian market with the commitment to invest in Indian NBFC, L&T Infra Debt Fund Ltd;

*c* Hatcher+, a data-driven VC firm that uses artificial intelligence and machine learning-based technologies to identify early stage opportunities in partnership with leading accelerators and investors worldwide invested an undisclosed amount of funding in Thane-based NapNap, creators of portable vibrating mats for children; and

*d* Ping’s Global Voyager Fund marked its venture into India by leading a Series D funding round of US$70 million in Indian automobile classifieds platform CarDekho.22

**ii Operation of the market**

**Equity incentive arrangements**

The structure and terms of equity incentives are key considerations for private equity sponsors to ensure maximum alignment of interests and, ideally, value creation for all participants. In buyout transactions, a private equity firm often involves future management in the due diligence process and the financial modelling.

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19 See footnote 3.
19 ibid.
21 ibid.
In India, common themes for equity incentive arrangements include the employee stock-option plan (ESOP), the employee stock-purchase plan (ESPP) (including sweet equity shares), stock appreciation right plans (SARs) or earn-out agreements. Allotment of shares under an ESOP or ESPP results in dilution of share capital, whereas SAR plans are non-dilutive in nature and are generally settled in cash. A company can award shares subject to performance or time-based conditions.

An EY survey shows that Indian organisations still prefer the conventional ESOP, where the Indian company typically sets up an employee trust to administer the ESOP scheme. Employees are given the option to purchase shares, and the option can be exercised after vesting in the employees. Usually, the share option plan is structured in such a way that shares will vest in tranches, which may be arranged to align with a period covering the anticipated duration of the PE investment. Typically, a stock-based incentive plan runs from five to 10 years. The EY survey revealed that 88 per cent of respondents have a vesting period of one to five years and to exercise this right an employee normally gets one to five years. Generally, the share options are non-transferable and cannot be pledged, hypothecated or encumbered in any way. A company can prescribe a mandatory lock-in period with respect to shares issued pursuant to the exercise of the share option. On termination of employment, the employee typically must exercise the vested options by the date of termination and any unvested options will generally be cancelled.

Under an ESPP, shares of the company are allotted up front to an employee, either at discount or at par, without any vesting schedule. In addition, the law also permits issuance of sweet equity shares, which are issued at a discount or for consideration other than cash to management or employees for their know-how, intellectual property or other value added to the company.

SARs entitle an employee to receive the appreciation (increase of value) for a specific number of shares of a company where the settlement of the appreciation may be made either by way of cash payment or shares of the company. SARs settled by way of shares of a company are referred to as equity-settled SARs. ‘Phantom stock options’ or ‘shadow stock options’ (phantom stock options), a popular nomenclature derived from usage for SARs, is a performance-based incentive plan that entitles an employee to receive cash payments after a specific period or upon fulfilment of specific criteria, and is directly linked to the valuation and the appreciated value of the share price of the company.

Since an ESOP has a vesting period, it is used as a means of retention, whereas an ESPP is mostly used to reward performance. Unlike an ESOP or ESPP, a SAR does not involve cash outflow from employees and is of advantage to an organisation by not diluting equity while, simultaneously, offering the economic value of equity to employees. However, for employees seeking an equity stake in the company, phantom stock options may not be an

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25 ibid.
27 See footnote 23.
attractive option. Prominent exit strategies for stock-based incentive plans typically entail employees selling shares on a stock exchange in the case of listed entities, and promoter buy-backs in the case of unlisted companies.28

Management equity incentives may also be structured through issuances of different classes of shares or management upside agreements (also called earn-out structures or incentive fee arrangements). Earn-out agreements are typically cash-settled or equity-settled agreements entered into between an investor and promoters or founders or key employees of a company, with the understanding that if the investor makes a profit on its investment at the time of its exit, a certain portion of the profit will be shared with those individuals. While giving investors a measure of control regarding the terms of an exit, earn-out agreements are also devised to incentivise and retain employees over a determined period. Typically, as the company is not a party to the agreement, the compensation is not charged to or recoverable from the company itself and these transactions are not reported within the ambit of related-party transactions entered into by the company. The policy argument against upside-sharing agreements is rooted in the possible conflict of interest between promoters and the management team in relation to the company and its other shareholders.29

In October 2016, the Securities and Exchange Board of India (SEBI), through its consultation paper on corporate governance issues in compensation agreements, observed that upside-sharing arrangements are ‘not unusual’, but ‘give rise to concerns’ and ‘potentially lead to unfair practices’, so it was felt that such agreements are ‘not desirable’ and hence it was ‘necessary to regulate’ these. In January 2017, SEBI amended the Securities and Exchange Board of India (Listing Obligation and Disclosure Requirements) Regulations (the SEBI Listing Regulations) in January 2017, to regulate upside-sharing arrangements to insert a new Regulation 26(6) under which prior approval would be required from the board of directors and shareholders of the listed company through an ordinary resolution for new upside-sharing agreements between an employee, including key managerial personnel or a director or promoter, and a shareholder or third party, provided that existing upside-sharing agreements would remain valid and enforceable, if disclosed to Indian stock exchanges for public dissemination, approved at the next board meeting and, thereafter, by non-interested public shareholders of the listed company.30

Increased regulation on upside-sharing may also dampen enthusiasm for PIPE deals, where secondary transfers occur between significant shareholders and investors through the block window of an Indian stock exchange or off-market transactions. Pending policy review, Indian companies and other stakeholders can continue to explore upside-sharing structures subject to appropriate corporate disclosure norms, or explore alternative capital raising and exit options.31

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28 ibid.
29 www.mondaq.com/india/s/758126/Shareholders/The+Ups+And+Downs+Of+UpsideSharing+Structures+In+India.
30 SEBI has been proactive in dealing with management incentive agreement issues by either issuing:
(1) show-cause notices to listed entities for violations of corporate governance and disclosure-related norms for failing to report incentive fee agreements (as in the case of PVR Limited in November 2016);
or (2) informal guidance on a variety of issues, including applicability of amendment to the SEBI Listing Regulations to management incentive agreements entered into with eligible employees of unlisted subsidiaries of listed entities (as in the case of Mphasis), and requirement of approval in cases of revival of a dormant incentive plan upon listing of an entity (as in the case of PNB Housing Finance Limited).
31 See footnote 29.
**Standard sales process**

According to the 2018 EY ‘Global Private Equity Divestment Study’, almost 61 per cent of PE executives now determine the right time to sell as being 12 months before the exit; up from 35 per cent in the 2017 study. The percentage of PE funds relying on opportunistic buyers has fallen from 54 per cent to 21 per cent. PE funds are spending more time positioning the business for exit, with a sale strategy established well in advance. A similar trend is also being witnessed in India with PE investors getting more pragmatic and less opportunistic in selling assets. The PE/VC space witnessed record-high exits in 2018, and almost 85 per cent of these happened through strategic sales, which grew sevenfold from 2017, while open-market transactions fell by more than half in 2018.32

Dealmaking in India traditionally has remained relationship-driven, involving identifying the target with high-quality assets from a shallow pool of assets in market; winning deals; establishing synergy with the founders, promoter groups or management; agreeing on indicative valuation; and entering into a term sheet. The term sheet has to be prepared in sufficient detail to cover the major terms and conditions of the potential transaction, indicative timelines for negotiation, finalisation and execution of definitive documents and completion of legal, technical and financial due diligence, and exclusivity and no-shop obligations.

However, in the past few years there has been a paradigm shift towards a controlled competitive bid model run by investment bankers or similar intermediaries. A seller-led trade sale process by way of a controlled auction has the following distinct advantages: (1) bringing more potential buyers into the sale process; (2) creating competition among bidders, thereby encouraging higher prices and more favourable terms for the seller (including diluted warranty and indemnity packages); (3) satisfaction of corporate governance concerns by maintaining transparency of process and superior control over flow of information, and securing the highest reasonably attainable price for stockholders; (4) ability to shorten the timelines by creating deadlines for submission of bids and completing various phases of the sale process; (5) a greater degree of confidentiality; and (6) greater control over the process. Given the lack in depth of quality assets in the Indian market, controlled bid processes have potential to unlock value and have fetched astronomically high valuations for highly desirable assets that were put on the block, thus making an auction sale an attractive option for the selling stakeholders.

A typical bid sale process usually entails the following stages.

**Phase I**

Phase I can be broken down into the following steps:

- **a** an approach is made by the seller’s investment banker to potential buyers;
- **b** a non-disclosure agreement is executed;
- **c** a process letter is circulated setting out in detail bid process rules, timelines and parameters for indicative proposals;
- **d** an information memorandum is circulated to potential bidders setting out meaningful information about the target (i.e., business model, strategy for growth, principal assets and limited financial information) to generate interest and elicit meaningful bids; and
- **e** on the basis of the information memorandum, the bidders submit an indicative proposal to the seller.

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Phase II
On the basis of a review of indicative proposals, bidders who are shortlisted to progress to the next phase of the sale process will be allowed access to the data room to conduct legal, financial environmental, technical and anti-corruption and anti-money laundering diligences. Preparation of vendor due diligence reports, by the target or the seller, for bidders is typically a standard feature in bid situations, so that the bidder’s own legal due diligence process can be conducted more effectively and in a timely manner. It is not unusual to see buyers in these situations conducting limited top-up due diligence checks to verify findings in the vendor due diligence reports.

Shortlisted bidders are also provided access to management presentations, interviews with the management and participation in site visits.

Templates of definitive agreements prepared by the seller are also provided to the shortlisted bidders for submission of their proposed mark-ups along with a final proposal by the end of this phase.

Phase III
Upon evaluating the final bids, and after taking into consideration the price offered and the terms bidders are seeking under the definitive documents, the process concludes with the selection of the winning bidder.

Phase IV
The final phase of an auction process is similar to a standard sale process where parties negotiate, finalise and execute definitive agreements.

One of the key drivers in negotiations is zeroing in on the structure that minimises tax leakage and is in compliance with the regulatory framework governing the transaction. After definitive documents are executed, deals may require regulatory approvals (typically these approvals may be from the governmental bodies, the RBI, SEBI or the Competition Commission of India (CCI), or any sector-specific regulator (such as insurance, telecoms or commodities exchanges)). The parties can proceed to closing upon satisfaction or waiver, to the extent permissible, of all conditions precedent (including obtaining any third-party consents). Closings typically occur anywhere between a few weeks (where no regulatory approvals are required) to three months (where regulatory approvals are required) after the execution of definitive documents. Depending on the management of the process, complexity of the sale assets, sector, the deal size, the parties and regulatory complexity a deal cycle may take anywhere between three months and one year from the signing of indicative offers of interest or longer where substantial restructuring of assets under a court-approved process has to be undertaken or where regulatory approvals are required.

In recent years, emerging trends in sale processes in India have included: (1) institutional sellers not providing any business warranties except in buyouts or control deals; (2) parties utilising escrow mechanisms and deferred consideration for post-closing valuation adjustments and indemnities; (3) target management facilitating trade sales and providing business warranties under contractual obligations under shareholders’ agreements or on account of receiving management upside-sharing incentives; (4) use of locked-box mechanisms; and (5) buyers arranging warranty and indemnity insurance to top up the diluted warranty and indemnity package obtained in competitive bid situations to ensure that meaningful protection is obtained.
II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Primary targets
Unlisted public companies or private limited companies are the most frequent investment targets for PE in India. The inefficiencies of India’s delisting regulations, the inability to squeeze out minority shareholders and the inability of PE investors to obtain acquisition finance are the primary reasons that make completion of ‘going-private’ deals unattractive for PE investors in India.

Key deal structures
Acquisition in India can be structured: (1) by way of merger or demerger; (2) in the form of an asset or business transfer; (3) in the form of a share acquisition; or (4) as a joint venture. Commercial and tax advantages are key considerations for investors when determining the structure for the transaction.

Legal framework
The principal legislation governing share purchases, slump sales, asset and business transfers, joint ventures and liquidation and insolvency in India comprises the Companies Act 2013 (the Companies Act), the Indian Contract Act 1872 (the Contract Act), the Specific Relief Act 1963 (the Specific Relief Act), the (Indian) Income Tax Act 1961 (the Income Tax Act), the Competition Act 2002 (the Competition Act) and the Insolvency Code. The Companies Act is the primary piece of legislation and governs substantive formation and operational aspects of companies, the manner in which securities of companies can be issued and transferred, mergers and demergers, and approval and effectuation of slump sales.

Matters of taxation in connection with acquisitions and disposals are governed by the provisions of the Income Tax Act. Under the Indian tax regime, a non-resident investor is subject to tax in India if it receives or is deemed to receive income in India; or income accrues or arises or is deemed to accrue or arise in India. A classical amalgamation and demerger is a tax-neutral transaction under the Income Tax Act, subject to the satisfaction of other specified conditions.

The inter se rights of the contracting parties are governed by the Contract Act and the Specific Relief Act. To achieve greater certainty on the enforceability of shareholders’ rights, the transaction documents of a significant number of transactions are governed by Indian law. However, transaction documents governed by foreign law and subject to the jurisdiction of foreign courts are also common. Arbitration governed by rules of major international arbitration institutions (including the International Chamber of Commerce, the London Court of International Arbitration and the Singapore International Arbitration Centre) with a foreign seat and venue is the most preferred dispute resolution mechanism for PE investors in deals in India.

The CCI is the competition regulator and has to pre-approve all PE transactions that fall above the thresholds prescribed in the Competition Act. While evaluating an acquisition, the CCI would mainly scrutinise whether the acquisition would lead to a dominant market position, affecting competition in the relevant market.

Transactions involving listed entities or public money are also governed by various regulations promulgated by the securities market regulator, namely SEBI. Direct and indirect acquisitions of listed targets that meet predefined thresholds trigger voluntary or mandatory
open offers, in accordance with the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 2011. In addition, parties have to be careful about price-sensitive information that may be disclosed in conducting due diligence on targets, as any sloppiness may have implications under the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations 2015. Clearances from SEBI are also required in transactions involving mergers or demergers of listed entities. Listing of securities is governed by the SEBI Listing Regulations.

The Banking Regulation Act 1949 specifically governs the functioning of banks and NBFCs under the supervision of the RBI in India. Relevant foreign exchange laws (including the Foreign Exchange Management Act 1999 and the rules and regulations framed under it (FEMA)) will apply in any cross-border investment involving a non-resident entity. Investments involving residents and non-residents are permissible subject to RBI pricing guidelines and permissible sectoral caps. PE investors typically invest in equity or preferred capital, or a combination of both via primary or secondary infusion. FEMA recognises only equity and equity-linked instruments (compulsorily convertible to equity) as permitted capital instruments. All other instruments that are optionally or not convertible into equity or equity-like instruments are considered debt, and are governed by separate regulations.

FEMA pricing guidelines prohibit foreign investors from seeking guaranteed returns on equity instruments in exits. However, with the advent of newer instruments such as rupee-denominated debt instruments (also known as masala bonds) and listed non-convertible debentures (NCDs), PE investors are utilising combination deals with hybrid structures to limit their equity exposure and protect the downside risk, by investing through a combination of equity or preferred capital and NCDs.

Furthermore, there are several pieces of sector-specific federal-level legislation, environmental legislation, intellectual property legislation, employment and labour legislation, and a plethora of state and local laws. One piece of legislation that is key in finalising deal dynamics is the Indian Stamp Act 1899, which provides for stamp duty on transfer or issue of shares, definitive documents, court schemes and the conveyance of immovable property.

ii Structuring and entry routes for offshore investors

Foreign investment is permitted in a company and limited liability partnership (LLP) subject to compliance with sectoral caps and conditions. However, foreign investment is not permitted in a trust, unless the trust is registered with SEBI as a VC fund, alternative investment fund (AIF), REIT or infrastructure investment trust (InvIT). Foreign PE investors can invest in India through the following entry routes.

**Foreign direct investment route**

Investors typically route their investments in an Indian portfolio company through a foreign direct investment (FDI) vehicle if the strategy is to play an active part in the business of the company. FDI investments are made by way of subscription or purchase of securities, subject to compliance with the pricing guidelines, sectoral caps and certain industry-specific conditions. Such investments are governed by the rules and regulations set out under the FDI consolidated policy (the FDI Policy), which is issued every year by the DPIIT of the Ministry of Commerce and Industry, and the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 (the Non-Debt Rules). The Non-Debt Rules supersede the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2017. While the changes introduced in the Non-Debt Rules were originally
not substantial, many changes have been pushed through individual amendments since its notification. Under the Non-Debt Rules, in line with the erstwhile regulations, any investment of 10 per cent or more of the post-issue paid-up equity capital on a fully diluted basis of a listed company will be reclassified as an FDI. In addition, the Non-Debt Rules stipulate that the pricing of convertible equity instruments is to be determined upfront and the price at the time of conversion should not be lower than the fair value at the time of issue of such instruments.

The Non-Debt Rules have been aligned with the SEBI (Foreign Portfolio Investors) Regulations 2019 (the FPI Regulations) to provide that a foreign portfolio investor (FPI) may purchase or sell equity instruments of an Indian company that is listed or to be listed subject to the individual limit of 10 per cent (for each FPI or an investor group) of the total paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants issued by an Indian company. The aggregate holdings of all FPIs put together (including any other permitted direct and indirect foreign investments in the Indian company) are subject to a cap of 24 per cent of the paid-up equity capital on a fully diluted basis or the paid-up value of each series of debentures, preference shares or share warrants. Such aggregate limit of 24 per cent can be increased by the concerned Indian company to up to the sectoral cap or statutory ceiling (as applicable) by way of a board resolution and a shareholders' resolution (passed by 75 per cent of the shareholders).

Previously, any investment in excess of the sectoral caps or not in compliance with the sectoral conditions required prior approval of the Foreign Investment Promotion Board (FIPB). In furtherance of its announcement in 2017, the government abolished the FIPB in 2017. In place of the FIPB, the government has introduced an online single-point interface for facilitating decisions that would previously have been taken by the FIPB. Upon receipt of an FDI application, the administrative ministry or department concerned will process the application in accordance with a standard operating procedure (SOP) to be followed by investors and various government departments to approve foreign investment proposals. As a part of its initiative to ease business further, the SOP also sets out a time limit of four to six weeks within which different government departments are required to respond to a proposal. More than two years on, there is very little information in the public domain about the proposals processed by the SOP.

**FPI route**

Foreign investors who have a short investment horizon and are not keen on engaging in the day-to-day operations of the target may opt for this route after prior registration with a designated depository participant (DDP) as an FPI under the FPI Regulations. The FPI Regulations supersede the erstwhile SEBI (Foreign Portfolio Investors) Regulations 2014 (the 2014 Regulations). The process of registration is fairly simple and ordinarily it does not take more than 30 days to obtain the certificate.

In 2014, to rationalise different routes for foreign portfolio investments and create a unified and single-window framework for foreign institutional investors, qualified institutional investors and sub-accounts, SEBI, the security watchdog, introduced the regulations on FPIs. In December 2017, SEBI, with the intention of providing ease of access to FPIs, approved certain changes to the FPI Regulations, which included: (1) rationalisation of fit-and-proper criteria for FPIs; (2) simplification of the broad-based requirement for FPIs; (3) discontinuation of requirements for seeking prior approval from SEBI in the event of a change of local custodian or FPI DDP; and (4) permitting reliance on due diligence carried
out by the erstwhile DDP at the time of the change of custodian or FPI DDP. In addition, with a view to improve ease of doing business in India, a common application form has been introduced for registration, the opening of a demat account and the issue of a permanent account number for the FPIs.

In 2019, SEBI introduced the FPI Regulations, with certain important changes from the 2014 Regulations, including:

a) the re-categorisation of FPIs into two FPI categories (rather than the three FPI categories under the 2014 Regulations). This will be done by the National Securities Depository Limited in consultation with the respective FPI DDPs;

b) for investment in securities in India by offshore funds floated by an asset management company that has received a no-objection certificate under the SEBI (Mutual Funds) Regulations 1996, registration as an FPI will have to be obtained within 180 days of the date of the FPI Regulations;

c) the broad-based requirement (where the fund was required to be established by at least 20 investors) for certain categories of FPIs has been done away with;

d) the concept of opaque structure has now been removed from the FPI Regulations such that the entities that are incorporated as protected cell companies, segregated cell companies or equivalent structures, for ring-fencing of assets and liabilities, can now seek registration as FPIs under the FPI Regulations. Having said that, under the 2014 Regulations, where the identity of the ultimate beneficial owner was accessible, such entities could fall outside the scope of opaque structures and, hence, obtain registration as an FPI. Similarly, while the concept of opaque structures has been removed under the FPI Regulations, FPIs need to mandatorily comply with the requirement of disclosure of beneficial owners to the SEBI; and

e) the total investment by a single FPI, including its investor group, must be below 10 per cent of a company’s paid-up equity capital on a fully diluted basis. If this threshold is exceeded, the FPI needs to divest the excess holding within five trading days of the date of settlement of trades resulting in the breach. The window of five trading days allows FPIs to avoid any change in the nature of their investments. However, upon failure to divest the excess holding, the entire investment in the company by the FPI (including its investor group) will be treated as an FDI, and the FPI (including its investor group) will be restricted from making further portfolio investments in terms of the FPI Regulations.

The clubbing of investment limits for FPIs is done on the basis of common ownership of more than 50 per cent or on common control. As regards the common-control criteria, clubbing shall not be done for FPIs that are: (1) appropriately regulated public retail funds; (2) public retail funds that are majority owned by appropriately regulated public retail funds on a look-through basis; or (3) public retail funds whose investment managers are appropriately regulated. The term ‘control’ is understood to include the right to appoint a majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights, by shareholders’ or voting agreements, or in any other manner.

Under the original FPI regime, Category I FPIs were restricted to those who were residents of a country whose securities market regulator was either a signatory to the International Organization of Securities Commission’s Multilateral Memorandum or had a
bilateral memorandum of understanding with SEBI. Hence, Category I FPIs were essentially governments and related entities or multilateral agencies and were perceived to be the highest-quality and lowest-risk investors.

Pursuant to the reclassification of FPIs, the entities that have been added to Category I, inter alia, are:

a. pension funds and university funds;
b. appropriately regulated entities, such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisers, portfolio managers, broker dealers and swap dealers;
c. appropriately regulated funds from Financial Action Task Force member countries;
d. unregulated funds whose investment manager is appropriately regulated and registered as a Category I FPI; and
e. university-related endowments of universities that have been in existence for more than five years.

In addition, the Category II FPI is the new residual category, which includes all the investors not eligible under Category I, such as individuals, appropriately regulated funds not eligible as Category I FPIs and unregulated funds in the form of limited partnerships and trusts. An applicant incorporated or established in an international financial services centre (IFSC) is deemed to be appropriately regulated under the FPI Regulations.

Market participants have welcomed all these changes as pragmatic steps by SEBI to enhance the flow of institutional capital into India.

**Foreign venture capital investor route**

The foreign venture capital investor (FVCI) route was introduced with the objective of allowing foreign investors to make investments in VC undertakings. Investment by such entities into listed Indian companies is also permitted subject to certain limits or conditions. Investment through the FVCI route requires prior registration with SEBI under SEBI (Foreign Venture Capital Investors) Regulations 2000 (the FVCI Regulations). Investment companies, investment trusts, investment partnerships, pension funds, mutual funds, endowment funds, university funds, charitable institutions, asset management companies, investment managers and other entities incorporated outside India are eligible for registration as FVCIs. One of the primary benefits of investing through the FVCI route is that FVCI investments are not subject to the RBI’s pricing regulations or the lock-in period prescribed by the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018.

Pursuant to the FVCI Regulations, FVCIs must register with SEBI before making investments. The process typically takes 20 to 30 days from the date of application. To promote job creation and innovation, the RBI allowed for 100 per cent FVCI investment in start-ups. In this regard, the Non-Debt Rules also allow FVCIs to purchase equity or equity-linked instruments or debt instruments issued by an Indian start-up, irrespective of the sector in which it is engaged subject to compliance with the sector-specific conditions (as applicable). Previously, only investment in the following sectors did not require prior approval of the securities regulator:

a. biotechnology;
b. information technology;
c. nanotechnology;
d. seed research and development;
pharmaceuticals (specifically in terms of discovery of new chemical entities);

dairy;
poultry;

biofuel production;

hotels and convention centres with a seating capacity of over 3,000; and

infrastructure.

iii Tax structuring for offshore investors

Double-taxation avoidance treaty

The tax treatment accorded to non-residents under the Income Tax Act is subject to relief as available under the relevant tax treaty between India and the country of residence of the investor. If the non-resident is based in a jurisdiction that has entered into a double-taxation agreement (DTA) with India, the double-taxation implications are nullified and the Indian income tax laws apply only to the extent they are more beneficial than the terms of the DTA, subject to certain conditions. PE investors structure investment through an offshore parent company with one or more Indian operating assets. Understandably, the primary driver that determines the choice of jurisdiction for offshore investing vehicle is a jurisdiction that has executed a DTA with India. Hence, the Income Tax Act is a major consideration in the structuring of a transaction. India has a comprehensive tax treaty network with over 90 countries, providing relief from double taxation.

Historically, non-resident sellers whose investments were structured through jurisdictions having a favourable DTA with India were exempt from paying capital gains tax. Because capital gains and dividends are non-taxable, and because of their low income tax rates, Mauritius, Singapore, Cyprus and the Netherlands were the most preferred jurisdictions of investors planning to invest into Indian companies.

The government renegotiated the DTAs with Mauritius, Singapore and Cyprus to provide India with the right to tax capital gains arising from transfer of shares acquired on or after 1 April 2017, with the benefit of grandfathering provided to investments made up until 31 March 2017. Equity shares acquired by investors based in Mauritius and Singapore on or after 1 April 2017 but transferred prior to 1 April 2019 will be taxed in India at 50 per cent of the applicable rate of domestic Indian capital gains tax; and shares acquired on or after 1 April 2017 but transferred on or after 1 April 2019 will be taxed at the full applicable rate of domestic Indian capital gains tax. Equity shares acquired by PE investors based in Cyprus on or after 1 April 2017 will be taxed at the applicable rate of domestic Indian capital gains tax. Compulsory convertible debentures and non-convertible debentures are exempt from capital gains tax for investors based in Mauritius, Singapore and Cyprus.

At present, except for a few DTAs (such as the Netherlands and France, subject to conditions), India has the taxing rights on capital gains derived from sales of shares. Having said that, in most Indian tax treaties, with limited exceptions (such as the United States and the United Kingdom), capital gains derived from hybrid, debt and other instruments (excluding shares in an Indian resident company) continue to be exempt from tax in India.

GAAR

To curb tax avoidance, the Indian government introduced the General Anti-Avoidance Rule (GAAR) with effect from 1 April 2017, with provision for any income from transfer of investments made before 1 April 2017 to be grandfathered. The GAAR has been introduced with the objective of dealing with aggressive tax planning through the use of sophisticated
structures and codifying the doctrine of ‘substance over form’. It is now imperative to demonstrate that there is a commercial reason, other than to obtain a tax advantage, for structuring investments out of tax havens. Once a transaction falls foul of the GAAR, the Indian tax authorities have been given wide powers to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of the entities and the legal situs of assets involved, treat debt as equity and vice versa, and deny DTA benefits.

Place-of-effective-management risk

Under the Income Tax Act tax residence forms the basis of determination of tax liability in India, and foreign company is to be treated as tax resident in India if its place of effective management (POEM) is in India. Pursuant to the POEM Guidelines, 33 POEM is ‘a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are in substance made’. 34 Where a foreign company is regarded to have a POEM in India, its global income is taxable in India at the rates applicable to a foreign company in India (at an approximate effective rate of 41.2 to 43.26 per cent). Accordingly, PE investors must exercise caution when setting up their fund management structures, and in some cases their investments, in Indian companies.

iv  Fiduciary duties and liabilities

The Companies Act has for the first time laid down the duties of directors of companies in unequivocal terms in Section 166, and these include:

a  to act in accordance with the articles of the company;

b  to act in good faith, and to promote the objects of the company for the benefit of its members as a whole and in the interests of the company, employees, shareholders, community and the environment;

c  to act with due and reasonable skill, care, diligence, and exercise independent judgement;

d  not to be involved in a situation that may lead to a direct or indirect conflict or possible conflict of interest with the company;

e  not to achieve or attempt to achieve any undue gain or advantage either for themselves or for their relatives, partners or associates (a director who is found guilty of making undue gains shall be liable to compensate the company); and

f  not to assign their office to any other person (such an assignment, if made, shall be void).

To mitigate the risk of nominee director liability arising out of any statutory or operational issues in target companies, PE investors should ensure that the investee company specifies one of the directors or any other person to be responsible for ensuring compliance with all operational compliance requirements. To safeguard their interest and avoid undue liability, it is advisable that directors attend meetings regularly and adopt a precautionary approach, including taking the following steps:

a  be inquisitive, peruse agendas for unusual items and seek additional information in writing, if necessary;

b  ensure that disagreements or dissenting views are recorded in the minutes;

33 Circular No. 6 of 2017 dated 24 January 2017 issued by the Central Board of Direct Taxes.
34 ibid.
c act honestly (with reasonable justifications) and report concerns about unethical behaviour, actual or suspected fraud or violation of the company’s code of conduct or ethics policy;

d seek professional advice, engage external agencies, if the situation demands it;

e regularly provide requisite disclosures of interests or conflicts, consider excusing oneself from participation in proceedings in cases of conflict; and

f include indemnity provisions in the letter of appointment and seek directors and officers liability insurance from the company to protect against malicious actions.

PE investors, as shareholders in target companies, do not have any additional fiduciary duties or any restrictions on exit or consideration payable for a fund domiciled in a different jurisdiction (from a fiduciary duty or liability standpoint). The inter se contractual rights between shareholders and the company shall be governed by the respective shareholders’ agreements. However, in a control deal, for certain regulatory purposes a majority investor may be viewed as a promoter.

III YEAR IN REVIEW

i Recent deal activity

In 2019, PE investments retained their momentum from 2018 and recorded deals worth US$36 billion as at 30 November 2019, an 11 per cent decline compared with 2018. GIC, Brookfield, Blackstone, Baring PE and SoftBank were the key PE investors by deal value in 2019. As per a VCCircle report, each of these firms committed at least US$1 billion for investment in India in 2019. The deal volume continued its downward trend in 2019, with fewer billion-dollar deals. PE witnessed a minor decline from seven mega billion-dollar deals in 2018 to five billion-dollar deals in 2019. Despite the slowdown in deal volume, deal value saw an upward trajectory, indicating an increase in the average ticket size.

Infrastructure-related industries accounted for 40 per cent of PE investments in 2019, attracting US$14.7 billion across 74 deals compared with a 20 per cent share in 2018, attracting US$7.8 billion across 83 deals. Energy sector deals, led by Brookfield’s US$1.9 billion investment in Reliance Pipeline Infra, accounted for 26 investments worth US$4.9 billion in 2019, compared with 31 transactions worth US$3.2 billion in 2018. The telecoms sector witnessed India’s biggest ever PE deal with Brookfield agreeing to invest almost US$3.7 billion in a special purpose vehicle (SPV) that will acquire a controlling stake in Reliance Jio’s tower infrastructure company. In another notable deal, GIC invested US$715 million in telecoms giant Bharti Airtel Limited. 2019 also witnessed investment of more than US$1 billion each in the airport development arms of the Hyderabad-based GMR and GVK groups.

Driven by a clean-up of the sector on account of the implementation of the Real Estate (Regulation and Development) Act 2016 and demonetisation, the successful listing of India’s first REIT, Embassy Office Parks REIT, by Blackstone and the Embassy group, and the availability of attractive yield-generating commercial assets due to the liquidity crunch faced

35 See footnote 3.
37 See footnote 3.
by real estate developers, the real estate sector witnessed increased PE interest from domestic and foreign funds. Blackstone, Brookfield and GIC continued acquisition of real estate projects, including new commercial projects.

Notable deals included Brookfield acquiring Hotel Leela Venture Limited for US$556 million; GIC setting up a portfolio of US$600 million with Indian Hotel Company Limited to acquire hotels in India; and Blackstone’s acquisitions of Coffee Day’s tech park for approximately US$400 million, Indiabull’s office properties for approximately US$624 million and Radius Group’s One BKC for US$357 million.

Topped by a new US$1 billion investment in Alibaba-backed fintech leader PayTM, IT and IT-enabled companies accounted for 32 per cent of PE investments in 2019, attracting US$11.8 billion across 493 deals compared with US$10.9 billion across 482 deals in 2018.39

2019 witnessed the advent of nine new ‘unicorns’, namely Delhivery, Dream11, BigBasket, Rivigo, Druva Software, Icertis, Citius Tech, Ola Electric and Lenskart.

PwC report that buyout activity in 2019 broke all previous records and surpassed deals by 30 per cent in terms of value. Control transactions have become a key driver for dealmaking by PE investors in India to extract maximum value. Blackstone PE continued with its strategy of focusing on acquiring control in prime assets and acquired controlling stakes in Aadhar Housing and Essel Propack, while Carlyle invested US$653 million in SBI Life Insurance. Keeping up with the trend, Baring PE Asia sealed three technology deals in 2019, acquiring NIIT Technologies for US$872 million, CitiusTech for US$800 million and AGS Health for US$339 million. Advent sealed six deals, largely in the consumer, financial services and healthcare segments, and acquired DFM Foods Ltd, Enamor, Dixcy Textiles Pvt Ltd and Bharat Serums and Vaccines Ltd. General Atlantic put money into Rubicon Research and NoBroker, and topped up its investments in PNB Housing and BYJU’S.40

The top five PE transactions of 2019 by deal value are as follows.41

<table>
<thead>
<tr>
<th>Company</th>
<th>Investor</th>
<th>Industry</th>
<th>Deal value (US$ billions)</th>
<th>Stake (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reliance Tower Infrastructure Trust</td>
<td>Brookfield</td>
<td>Telecoms</td>
<td>3.7</td>
<td>N/A</td>
</tr>
<tr>
<td>Reliance Pipeline Infrastructure India</td>
<td>Brookfield</td>
<td>Energy</td>
<td>1.9</td>
<td>100</td>
</tr>
<tr>
<td>GMR Airports Holding</td>
<td>SSG Capital, GIC, others</td>
<td>Travel and transport</td>
<td>1.1</td>
<td>44.4</td>
</tr>
<tr>
<td>GVK Airport Holdings</td>
<td>NIIF, ADIA, PSP Investments</td>
<td>Travel and transport</td>
<td>1.1</td>
<td>N/A</td>
</tr>
<tr>
<td>PayTM</td>
<td>Alibaba, SoftBank Corp and others</td>
<td>Technology</td>
<td>1</td>
<td>6.25</td>
</tr>
</tbody>
</table>

Limited partners, SWFs, pension funds, PIPE deals and platform plays

India continued to attract the interest of very deep-pocketed SWFs, traditional limited partners (LPs) and pension funds, and all stepped up their investments in India. SWFs have been a part of over 18 per cent (in terms of value) of the PE investments made in the country between 2014 and 2018. SWFs from across the globe, particularly Canada, Singapore and Abu Dhabi, were a part of some of the largest PE transactions in 2019, with involvement in around 24 per cent of PE deals in 2019.42 SWFs have been relatively active in the renewables

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39 ibid.
40 ibid.
41 See footnote 3.
42 See footnote 3.
space, having been a part of some of the largest deals in this segment. These funds have not only demonstrated interest in energy, financial services, real estate and infrastructure, but have also jumped on the tech start-up bandwagon, demonstrating their growing risk appetite and possibly spurring competition with the VC community.43

LPs that were traditionally funds of funds and used to funnel money to PE and VC funds, are increasingly investing directly in companies, often co-investing with the general partners (GPs) backed by them. The key reasons behind the paradigm shift over the past five years include: (1) additional flexibility and choice in investment decisions; (2) the healthy growth potential of the Indian market on account of improvement in ease of doing business and the reform agenda; (3) co-investments help in improving returns, as LPs do not pay any incremental management fee to the GPs; and (4) availability of significant funds for direct investment in India. Direct investment by LPs in the Indian market over the past 10 years adds up to in excess of US$20 billion. GIC, Temasek, International Finance Corporation, Abu Dhabi Investment Authority, CPPIB, Caisse de Dépôt et Placement du Québec (CDPQ) and PSP are a few of the very deep-pocketed LPs who have invested in Indian markets. The number of PIPE deals has seen strong growth on account of large LPs investing directly in India. The US$1.7 billion investment by GIC, KKR, Premjiinvest, OMERS and others in HDFC Bank Ltd in 2018 was one of the biggest PIPE deals backed by LPs.

GIC's investment of US$1.4 billion for a 33 per cent stake in the rental arm of DLF is the largest investment in the Indian real estate sector. Continuing the trend in 2019, GIC retained its position as the most active private equity style investor in India and committed between US$2.5 billion and US$3 billion in the infrastructure and real estate sectors.44 GIC invested money in GMR Airports, Bajaj Finance, SBI Life Insurance, Godrej Properties and Endurance Technologies and Greenko Energy Holdings in 2019 and also set up a joint venture with Tata Group's Indian Hotels Company Ltd to acquire hotels in India. GIC also came in as a co-investor alongside Brookfield to acquire Reliance Jio Infocomm Ltd's telecoms towers for US$3.7 billion in India's largest ever PE deal. GIC was also a co-investor with KKR to acquire IndiGrid Trust sponsor Sterlite Investment Managers for US$400 million.45 In one of the biggest PIPE deals, GIC acquired an approximate 4 per cent stake in Bharti Airtel Limited for US$726 million.

Other notable PIPE and SWF deals of 2019 included co-investment of US$817 million by CPPIB and Carlyle in SBI Life Insurance; CDPQ acquiring three road assets of Essel Infraprojects Limited for US$500 million and investing US$247 million in Piramal Enterprises Limited; CPPIB investing US$200 million in L&T IndInfraVit Trust; and Invesco Oppenheimer Developing Markets Fund investing US$613 million in Zee Entertainment Enterprises Limited.46

Platform deals allow funds to channel their expertise into specific sectors or focus areas. Consolidation, through platforms to establish dominance in select sectors by merging portfolio companies or through leading sectoral consolidation, has not remained limited

43 See footnote 2.
44 See footnote 36.
45 ibid.
to strategic investors but become a dominant theme for PE players. PE funds and SWFs have already entered into agreements with domestic participants to cater to segments such as infrastructure, real estate, renewables, healthcare and, most importantly, stressed assets. Consolidation is key to improving size, scalability and operating models. PE funds such as Warburg Pincus, Goldman Sachs, Everstone, Blackstone and KKR, along with SWFs such as GIC, CPPIB, Abu Dhabi Investment Authority and Qatar Investment Authority, have demonstrated tremendous appetite for creating new platforms.47

The investor-friendly modifications to REIT regulations have resulted in global investors such as Blackstone and Brookfield, and SWFs such as GIC Singapore picking up large quality office assets to build up their REIT portfolios. 2019 saw the launch of India’s first REIT, Embassy Office Parks REIT, by Blackstone and the Embassy group. SWFs are investing as anchor investors in platform funds, as well as entering into joint ventures with developers. Phoenix Mills Ltd and CPPIB formed an investment platform of around US$250 million in 2016, while APG-Xander Group has been co-investing US$450 million in the retail segment since 2017. Other selective platform deals across the segment were Abu Dhabi Investment Authority and HDFC Capital platforms in the affordable housing segment for US$450 million and US$550 million, respectively; Qatar Investment Authority’s co-investment with RMZ Corp Ltd in the commercial segment for US$300 million; and the CPPIB platform with Indospace Ltd in the industrial segment with US$500 million.48

Platforms seem to be the winning PE formula, as demonstrated by KKR backing Radiant Life Care Private Limited’s acquisition of Max Healthcare; Warburg Pincus LLP’s joint venture with Lemon Tree Hotels Limited to develop student housing and co-living space in India; TPG’s belief in Vishal Bali’s healthcare venture Asia Healthcare Holdings; Everstone’s foods platform following its acquisitions of Modern Foods, through which it snapped up Cookie Man; and Goldman Sachs backing up Sumant Sinha to grow ReNew. Even India’s very own sovereign fund, National Investments and Infrastructure Fund (NIIF), has joined forces with DP World for a US$3 billion infrastructure platform for ports, terminals and logistics. Platform play is a symbiotic relationship allowing funds to enter into cherry-picked sectors, to drip-feed capital into platforms as they grow and providing the ability to ride the momentum by scaling up through bolt-on acquisitions or ‘roll-ups’.49

In 2019, Singapore’s Temasek and Sweden’s EQT set up a renewable energy platform, O2 Power, in India, with an equity capital commitment of US$500, which will build solar and wind farms with total capacity of 4 gigawatts.50 Other investments saw CPPIB committing US$600 million in NIIF and Blackstone setting up a warehousing platform with Hiranandani Group.

PE-backed platforms make a lot of sense in fragmented and capital-heavy sectors such as warehousing, logistics and financial services. Platform plays allow PE firms greater flexibility

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during deployment and when investing in scattered assets, while also allowing them to club all the investment into a bigger pool, which can be sold to a large PE or strategic investor or flipped into investment trusts such as REITs and InvITs.\textsuperscript{51}

\textit{Distressed-asset space – the Insolvency and Bankruptcy Code 2016}

The Insolvency and Bankruptcy Code 2016 (the Insolvency Code) proved to be not only a major factor in improving India's ranking by the World Bank for ease of doing business, but also one of India's most important economic and corporate regulatory reforms. The Insolvency Code came at a time when the asset bubble had all but burst and the Indian banking system was collapsing on account of unprecedented amounts of non-performing assets (NPAs). The Insolvency Code gave teeth to the efforts to reform the banking and financial sector. Stressed assets have spiked the interest of global and domestic players, and the opportunity to strategically capitalise on a supply of NPAs across a number of core sectors at steep discounts has created fierce competition and a dealmaking frenzy in the distressed-asset sector.

With banks stepping up their efforts to clean out their balance sheets of NPAs and bad loans, providing unprecedented supply to asset reconstruction companies (ARCs), PE funds and SWFs are tying up with ARCs and setting up distressed funds to establish their footprint in the distressed space. According to PwC, the number of ARCs in India has increased to 29 from 16 in 2016. After government allowed foreign institutions to have 100 per cent ownership in ARCs, the RBI further sweetened the deal for PE participants by permitting listing of security receipts in December 2017.

Major global PE funds such as Blackstone, KKR, Apollo Global Management and Baring Private Equity Asia have either already set up or announced private credit platforms in India. Blackstone has acquired a controlling stake in distressed-asset buyer International Asset Reconstruction Company Private Limited, investing about US$150 million. KKR has been one of the early movers to tap private credit opportunities in India, acquiring a licence to operate an asset reconstruction company in India in December 2017. AION Capital, which is a joint venture between ICICI Bank and Apollo Global Management, also received the RBI’s nod to start an ARC in 2018. Among domestic private credit funds, the Edelweiss group has tied up with CDPQ, and Piramal Enterprises has teamed up with Bain Capital Credit to form India Resurgence Fund, to acquire distressed assets.

According to experts, the size of the market in opportunities in the NPA space is pegged at US$150 billion.\textsuperscript{52} According to EY data, in anticipation of opportunities to invest at the right valuations, in 2016 and 2017, PE funds launched several dedicated stressed-asset funds, of approximately US$4 billion in aggregate. In January 2019, Edelweiss Financial Services Ltd closed its distressed-assets-focused fund EISAF II, raising a corpus of US$1.3 billion,\textsuperscript{53} clearly demonstrating not only the firepower of PE-backed ARCs, but also the bullish view of PE funds and SWFs in the stressed-asset sector.

The stressed-asset space is in a very nascent stage in India and the first round of the great Indian distressed-asset sale (centred primarily around 12 large cases referred by the RBI under the Insolvency Code mechanism) belonged to strategic participants, which emerged on top

\textsuperscript{51} See footnote 47.
\textsuperscript{52} www.vccircle.com/partnership-model-drives-distressed-assets-opportunity-panellists-at-vccircle-event.
\textsuperscript{53} www.livemint.com/Companies/yRYQevho6OdXRDJ3VCR7SN/Edelweiss-raises-13-billion-to-acquire-India-assets.html.
because of their ability to bid higher, and with a longer time horizon, than PE investors. As at December 2019, seven of the infamous dirty dozen cases amounting to US$45 billion have already been resolved.\textsuperscript{54}

In the three years to November 2019, the Insolvency Code recorded resolution of an aggregate 167 cases out of which 81 cases were resolved during 2019 itself. In terms of recovery, the Insolvency Code helped recover 1.57 trillion rupees of unpaid bank loans and money due to vendors, amounting to 42 per cent of the total amount due. These figures comprise cases that were actually brought before the adjudicating authorities. Considering the number of successful resolutions under the Insolvency Code prior to their admission by the adjudicating authority, the Insolvency Code might have helped the recovery of about 5 trillion rupees of unpaid dues. In 2019, the Insolvency Code saw one of the biggest resolutions, and one of the largest FDI inflows, involving an amount of 420 billion rupees for the acquisition of Essar Steel by ArcelorMittal.\textsuperscript{55}

With debt-laden groups being forced to sell their prized assets to deleverage their books and to avoid being dragged to insolvency courts by their creditors, Blackstone Group Inc, Warburg Pincus and several other PE firms in India took advantage of the situation and snapped up some attractive assets. While Blackstone acquired assets such as Aadhar Housing, Essel Propack and Coffee Day technology office park, Warburg Pincus acquired an 80 per cent stake in the education loan arm of financial services group Wadhawan Global Capital Ltd.

\textbf{ii  Financing}

Any form of acquisition financing is limited to offshore sources, which can be problematic given restrictions on the creation of security on Indian assets in favour of non-resident lenders. Indian exchange control regulations prohibit Indian parties from pledging their shares in favour of overseas lenders if end use of the borrowing is for any investment purposes directly or indirectly in India. Indian companies that are foreign owned or controlled are prohibited from raising any debt from the Indian market to make any further downstream investments. In addition, Indian entities are not permitted to raise external commercial borrowings for the purposes of acquisition of shares. In addition, the Companies Act restricts public companies (including those deemed public companies) from providing any direct or indirect security or financial assistance for the acquisition of their own securities.

The less stringently regulated privately placed NCDs (which are outside the purview of the external commercial borrowing regime), which can be secured by Indian assets, have emerged as a form of debt financing for foreign PE investors. NCDs issued to FPIs are no longer mandatorily required to be listed. Indian masala bonds, which may be issued to overseas lenders, have emerged as another option for debt financing. However, PE investors are reluctant to use masala bonds to finance domestic acquisitions, since there is prevailing view that proceeds raised through the issuance of masala bonds cannot be used for capital markets and domestic equity investments.

Given that acquisition financing is virtually non-existent in India, PE investors, for Indian transactions, traditionally deploy their own funds or funds leveraged offshore, which

\textsuperscript{54} See footnote 3.

are subsequently brought as equity into India. In auction processes and large transactions, it is common for the seller to request equity commitment letters or financing arrangements to demonstrate the purchaser’s ability to perform its obligations.

iii Key terms of control transactions

**Control deals and a paradigm shift in India**

Investors are showing greater appetite for control deals in India. According to PwC, buyout deals have witnessed an increase in value of nearly 25 per cent compared to 2017. From 2015 onwards there have been several notable control transactions completed by PE investors, showcasing a shift towards acquiring a majority stake in target companies. Over the years, PE investors have garnered considerable insight about the challenges of working with Indian promoters, which include information asymmetry, insufficient middle management talent, limited exposure to best practices, and inadequate reporting and governance structures.56

Investors are the key driving factors behind this paradigm shift:

- they want to achieve better corporate governance;
- there has been a significant increase in the expertise and in capability of PE investors to add value to their portfolio companies operationally;
- they want better operational control;
- they want to generate better returns on their investments;
- they want more control over exit opportunities and processes;
- there has been an increase in platform deals;
- there are larger amounts of capital available to invest; and
- there has been an increase in the number of co-investors with whom to share risk.

Control deals in India are based on two models: (1) the PE investor will either hire a fresh management team with a buyout of a majority stake or the whole company from the existing shareholders; or (2) the PE investor will acquire a majority stake or the whole company, with the pre-existing management team staying on.

According to a report by Alvarez & Marsal, in a typical control deal PE firms utilise the following structure with interventions in the deal cycle in India:

- **pre-deal:** in-depth pre-deal due diligence checks of a target, with a focus on ensuring the presence of a good management team and identification of revenue enhancement opportunities;
- **early holding period** (the initial six to 12 months): setting the direction by acquisition of ‘senior talent’ and ‘aligning objectives with management’ and launching value creation initiatives;
- **middle holding period:** performance, execution, monitoring of value creation initiatives and selective intervention on key issues; and
- **pre-exit:** preparing for a successful exit by ensuring alignment with the promoter and company management.57

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57 Ibid.
As an emerging trend, PE firms use the following models for value creation: (1) using a dedicated operating team; (2) hiring industry or functional experts who are proven leaders in the relevant sector with the ability to accelerate value creation; or (3) engaging external consultants.

**Key terms and conditions**

Key terms in recent control transaction in India include: (1) robust pre-deal due diligence to identify any legal, operational or financial issue; (2) robust business warranties backed by an indemnity from an entity of substance (which can include parent guarantees); (3) use of an escrow mechanism and deferred consideration for post-closing valuation adjustments and indemnities; (4) provision of management upside-sharing incentives to retain and incentivise management; and (5) use of a locked-box mechanism to protect value.

**Challenges**

Control transactions suffer from their own challenges in India, including the following:

a. restrictions on account of regulations relating to tender offers in listed company acquisitions, and exchange control regulations relating to FDI in sectors having investment caps. Under Indian exchange control regulations, FDI in certain regulated sectors is not permitted beyond a specified limit;

b. limited availability of acquisition finance in India;

c. provisions involving a non-resident with respect to earn-outs, deposits and escrows must comply with the criteria set out by the RBI. In India, in the case of a transfer of shares between a resident buyer and a non-resident seller, or vice versa, up to 25 per cent of the total consideration can be paid by the buyer on a deferred basis from the date of the agreement or 25 per cent of the total consideration can be furnished as an indemnity for a period not exceeding 18 months from the date of payment of the full consideration;

d. in exits by way of a secondary sale, the acquirer is likely to seek business warranties and indemnities (backed by an entity of substance) from existing PE investors; and

e. in exits by way of an initial public offering (IPO) on the Indian stock exchanges, the controlling PE investor is likely to be classified as a promoter under applicable securities regulations and may be subject to lock-in and other restrictions.

**Control deals in 2019**

Control has become a key element and deal driver in most transactions. Continuing with the trend of 2018, dealmaking in 2019 also saw a fair share of control deals and buyouts, which constituted 35 per cent of PE investments (excluding real estate).\(^58\) One of the largest control deals was Brookfield’s acquisition of 90 per cent of RIL’s East West Pipeline for approximately US$1.888 billion. Certain other buyouts included Brookfield acquiring a 100 per cent stake in Hotel Leela Venture Limited for US$572 million; CDPQ acquiring a 100 per cent stake in Essel Infraprojects Limited (three road assets) for US$500 million; Baring Asia Private Equity acquiring a controlling stake in AGS Health Private Limited for US$339 million and an 80 per cent stake in Citius tech Healthcare Technology Private Limited for US$800 million; and Blackstone acquiring a controlling stake in Indiabulls

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\(^{58}\) See footnote 3.
Real Estate’s commercial properties for approximately US$624 million, Coffee Day’s Global Village Tech Park for approximately US$400 million and a 51 per cent stake in Essel Propack Limited for US$310 million.59

iv Exit

2018 marked an inflection point for the PE/VC industry in India, with exits at US$26 billion, which approached the value of investments, demonstrating that the industry is moving towards mature market standards.60 However, this was on account of a single large strategic sale when Walmart bought a controlling stake in Flipkart for US$16 billion from a clutch of investors, including SoftBank Group Corp and Tiger Global.

Compared with 2018, 2019 saw a sharp decline in PE exits in terms of value and volume, recording 185 exits worth a little over US$9.5 billion. This was a 63 per cent decline in terms of value compared to 2018.61

Public market sales accounted for the largest share of the exit value in 2019, up 45 per cent compared to 2018. Open market transactions accounted for the highest share of the exit value within public market sales, while IPOs witnessed a 67 per cent drop in comparison to 2018. Secondary sales and buy-backs amounted to nearly US$2 billion each.62 The year also saw Lightspeed Venture Partners and Sequoia Capital India allegedly complete their transaction to sell about a 15 per cent stake in Gurugram-based hospitality unicorn OYO to founder Ritesh Agarwal for US$1.5 billion.63 The buy-backs highlight the potential of India entrepreneurs and also help relax concerns around profitable exits within the start-up space.64

2019 saw nearly 150 exit transactions compared with 170 exits in 2018, which included nearly five dozen deals where investors made a complete exit. According to VCCEdge, the following were the top exit deals by PE and VC firms on total deal value and annualised return in 2019.65

<table>
<thead>
<tr>
<th>Target company</th>
<th>Investor</th>
<th>Exit amount (US$ millions)</th>
<th>Investment amount (US$ millions)</th>
<th>Investment year</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICICI Lombard</td>
<td>Warburg Pincus</td>
<td>508</td>
<td>260</td>
<td>2017</td>
</tr>
<tr>
<td>Cancer Treatment Services</td>
<td>Asia Healthcare Holdings (TPG)</td>
<td>277</td>
<td>79</td>
<td>2016</td>
</tr>
<tr>
<td>HDFC</td>
<td>KKR</td>
<td>263</td>
<td>224</td>
<td>2018</td>
</tr>
<tr>
<td>DLF</td>
<td>GIC</td>
<td>243</td>
<td>182</td>
<td>2011</td>
</tr>
<tr>
<td>Mindtree</td>
<td>Nalanda Capital*</td>
<td>240</td>
<td>28</td>
<td>2009</td>
</tr>
</tbody>
</table>

59 See footnote 46.
61 See footnote 3.
62 ibid.
64 See footnote 3.
### Top PE/VC exits by internal rate of return (IRR)

<table>
<thead>
<tr>
<th>Target company</th>
<th>Investor</th>
<th>Exit amount (US$ millions)</th>
<th>IRR (%)**</th>
<th>Investment year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hindustan Foods</td>
<td>Sixth Sense Ventures</td>
<td>7.8</td>
<td>220</td>
<td>2016</td>
</tr>
<tr>
<td>Rubicon Research</td>
<td>Everstone Capital</td>
<td>126</td>
<td>92</td>
<td>2016</td>
</tr>
<tr>
<td>Future Supply Chain</td>
<td>SSG Capital</td>
<td>35</td>
<td>55</td>
<td>2014</td>
</tr>
<tr>
<td>Cancer Treatment Services International</td>
<td>Asia Healthcare Holdings (TPG)</td>
<td>277</td>
<td>50</td>
<td>2016</td>
</tr>
<tr>
<td>Spinny</td>
<td>Indian Angel Network</td>
<td>750</td>
<td>45</td>
<td>2016</td>
</tr>
</tbody>
</table>

** VCCircle estimates are based on disclosures and market sources

However, as per the preliminary EY data available on deals up to 30 November 2019, the following were the top 10 exits in 2019.

<table>
<thead>
<tr>
<th>Company</th>
<th>Sector</th>
<th>Seller</th>
<th>Buyer</th>
<th>Exit type</th>
<th>Deal value (US$ millions)</th>
<th>Stake (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oravel Stays Private Limited</td>
<td>E-commerce</td>
<td>Lightspeed, Sequoia</td>
<td>Ritesh Agarwal</td>
<td>Buy-back</td>
<td>1,500</td>
<td>23.7</td>
</tr>
<tr>
<td>ICICI Lombard General Insurance Company Limited</td>
<td>Financial services</td>
<td>Fairfax</td>
<td>N/A</td>
<td>Open market</td>
<td>732</td>
<td>9.9</td>
</tr>
<tr>
<td>Genpact Limited</td>
<td>Technology</td>
<td>Bain Capital, GIC</td>
<td>N/A</td>
<td>Open market</td>
<td>625</td>
<td>14.6</td>
</tr>
<tr>
<td>SBI Life Insurance Company Limited</td>
<td>Financial services</td>
<td>Carlyle</td>
<td>N/A</td>
<td>Open Market</td>
<td>393</td>
<td>3</td>
</tr>
<tr>
<td>CitiusTech Healthcare Technology Private Limited</td>
<td>Healthcare</td>
<td>General Atlantic</td>
<td>Baring PE Asia</td>
<td>Secondary</td>
<td>389</td>
<td>32</td>
</tr>
<tr>
<td>Global Health Private Limited (Medanta)</td>
<td>Healthcare</td>
<td>Carlyle, Temasek</td>
<td>Manipal Hospitals</td>
<td>Strategic</td>
<td>377</td>
<td>46</td>
</tr>
<tr>
<td>ICICI Lombard General health Insurance Company Limited</td>
<td>Financial services</td>
<td>Fairfax</td>
<td>N/A</td>
<td>Open market</td>
<td>362</td>
<td>5</td>
</tr>
<tr>
<td>Genpact Limited</td>
<td>Technology</td>
<td>Bain Capital, GIC</td>
<td>N/A</td>
<td>Open market</td>
<td>324</td>
<td>5</td>
</tr>
<tr>
<td>Cancer Treatment Services International Inc</td>
<td>Healthcare</td>
<td>TPG</td>
<td>Varian Medical Systems Inc.</td>
<td>Strategic</td>
<td>283</td>
<td>N/A</td>
</tr>
<tr>
<td>Housing Development Finance Corporation Limited</td>
<td>Financial services</td>
<td>KKR</td>
<td>N/A</td>
<td>Open market</td>
<td>270</td>
<td>1</td>
</tr>
</tbody>
</table>

### IV REGULATORY DEVELOPMENTS

#### i Relevant regulatory bodies

In the context of PE investments, the relevant regulatory bodies in India are as follows.

a The RBI: the central bank and monetary policy authority of India. It is also the foreign exchange regulator and executive authority for FEMA, responsible for notifying regulations on various aspects of foreign exchange and investment transactions from time to time.

b SEBI: India’s capital markets regulator, which regulates all stock market activity. SEBI regulations are applicable when PE firms deal with listed securities.
CCI: the competition regulator, which is required to pre-approve all PE transactions that fall above the thresholds prescribed in the Competition Act.

Other sectoral regulators: depending on the sector where the PE investor makes an investment, there may be sectoral regulators who will also oversee the investment; for example, the Ministry of Corporate Affairs (MCA) oversees corporate affairs, the RBI oversees banks and financial services companies, the Insurance Regulatory Development Authority oversees the insurance sector, the Telecom Regulatory Authority of India oversees the telecommunications sector and the Directorate General of Civil Aviation oversees the aviation sector.

ii  Key regulatory developments

Amendments to the FDI Policy

The DPIIT made certain noteworthy changes to the FDI Policy during 2019 in its attempt to make India an attractive destination for FDI flows. Such changes include the following:

a  100 per cent FDI is now permitted under an automatic route in entities that are engaged in the sale of coal and coal mining activities including coal washing, crushing, handling and separation (magnetic and non-magnetic);

b  100 per cent FDI is now permitted under an automatic route for contract manufacturing and, accordingly, the entity with the FDI can undertake the manufacturing activities itself or through contract manufacturing, on either a principal-to-principal basis or a principal-to-agent basis. It has been clarified by the DPIIT that the investee entity will be deemed to be a manufacturing entity itself even if the manufacturing is done by a third-party contractor, provided that it is done under a legally tenable contract. In addition, the entity that has outsourced the manufacturing to the third-party contractor will be eligible to sell the manufactured product through wholesale, retail or e-commerce on the same footing as an entity that manufactures directly; and

c  26 per cent FDI has been permitted under the approval route in entities that are engaged in uploading or streaming news and current affairs through digital media.

National Guidelines on Responsible Business Conduct 2019

The MCA has revised and updated the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business of 2011 and issued the National Guidelines on Responsible Business Conduct 2019 (NGRBC). The revised guidelines have been aligned with the United Nations (UN) Sustainable Development Goals, the UN Guiding Principles for Business and Human Rights, the Paris Agreement on Climate Change, International Labour Organization core conventions Nos. 138 and 182 on child labour, and annual business responsibility reports mandated by SEBI and the Companies Act 2013, including recent amendments with respect to corporate social responsibility.

As with the earlier guidelines, the NGRBC is designed to assist businesses to perform above and beyond the requirements of regulatory compliance. The NGRBC applies to all businesses irrespective of their ownership, size, structure or location, including foreign multinational corporations investing or operating in India. They are also a guide for Indian multinational companies in their overseas operations. They encourage businesses to not only follow these guidelines in the context of business over which they have direct control and influence but also for their suppliers, vendors, distributors and collaborators. A committee
on business responsibility reporting constituted by the MCA will develop formats for listed and unlisted companies to report on their business responsibilities. This is expected to boost investor confidence and increase their creditworthiness.

**REITs and InvITs**

The MCA has amended the Companies (Acceptance of Deposits) Rules 2014 (the Deposit Rules) to exclude any amount received by a company from a REIT from the purview of ‘deposit’ under Rule 2(1)(c)(xviii) of the Deposit Rules. This follows the previous amendments, which excluded amounts received from AIFs, domestic VCFs, InvITs and mutual funds registered with SEBI.

In April 2019, SEBI notified amendments to the REIT Regulations and the Infrastructure Regulations. Some of the key changes include a reduction in the minimum subscription from any investor in any publicly issued InvIT from 1 million rupees to 100,000 rupees. In the case of a publicly listed REIT, the minimum subscription amount has been reduced from 200,000 rupees to 50,000 rupees. In addition, the minimum trading lot has been reduced from 500,000 rupees to 100,000 rupees. This is expected to increase the reach of retail investors to real estate and infrastructure projects, which was earlier limited due to high minimum investment requirements involved in investments through AIFs. Prior to the 2019 amendments, the aggregate consolidated borrowings and deferred payments of a listed InvIT, its holding company and SPVs were capped at 49 per cent of the value of InvIT assets, which restricted the ability of InvITs to make further acquisitions and provided for limited returns as compared to AIFs. Such limit has now been increased to 70 per cent of the value of InvIT assets subject to certain conditions such as obtaining a prior approval of 75 per cent of the unitholders and utilisation of funds only for the purpose of acquisition or development of the infrastructure projects or real estate projects. Unlisted private InvITs have received a much-anticipated relaxation of the rules in terms of the minimum number of investors, which is now at the discretion of the InvITs (capped at 20 members). The leverage limit of these private InvITs is to be specified under the trust deed (in consultation with the investors).

SEBI has also issued certain clarifications in relation to InvITs that issue units on a private placement basis, which are proposed to be listed. With effect from 15 January 2020, a draft placement memorandum is to be filed with SEBI and recognised stock exchanges through a SEBI-registered merchant banker, at least 30 days prior to the opening of the issue. The memorandum must contain disclosures as specified in the Infrastructure Regulations and should be submitted along with a due diligence certificate issued by the merchant banker. Upon perusal of the placement memorandum, SEBI may issue observations (if any) on such placement memorandum within 15 days of the later of: (1) receipt of the draft memorandum, (2) receipt of additional information or clarification from the issuer or the regulatory authority, or (3) receipt of an in-principle approval from the stock exchanges. It will be the merchant banker’s responsibility to ensure that all such comments are suitably incorporated in the draft placement memorandum and provide a due diligence certificate as per the prescribed format.

Further in a major boost to InvITs, the RBI has permitted banks to lend to InvITs subject to the following conditions:

- the bank has put in place a board-approved policy on exposures to InvITs that shall, inter alia, cover the appraisal mechanism, sanctioning conditions, internal limits and monitoring mechanism;
the bank undertakes assessment of all critical parameters including sufficiency of cash flows at InvIT level to ensure timely debt servicing. The overall leverage of the InvITs and the underlying SPVs put together shall be within the permissible leverage as per the bank's board-approved policy. Banks must also monitor the performance of the underlying SPVs on an ongoing basis as the ability of InvITs to meet their debt obligation will largely depend on the performance of these SPVs. As InvITs are trusts, banks should keep in mind the legal provisions in respect of these entities, especially those regarding enforcement of security;

c  the bank may only lend to InvITs where none of the underlying SPVs, which have existing bank loans, are facing ‘financial difficulty’, as defined in Paragraph 2 of Annex-I to Circular DBR No.BP.BC.45/21.04.048/2018-19 dated 7 June 2019;

d  the bank financing InvITs for acquiring equity of other entities shall be subject to the conditions given in Paragraph 2.3.7.4(iv) of the Master Circular on Loans & Advances – Statutory & Other Restrictions dated 1 July 2015; and

e  the audit committee of the bank's board must review the bank's compliance with the above conditions on a half-yearly basis.

Harmonisation of IFSC-incorporated AIF investment provisions

In August 2019, SEBI harmonised the provisions governing investments by AIFs incorporated in IFSCs with the provisions governing investments applicable to domestic AIFs such that the AIFs incorporated in IFSCs are permitted to make investments in accordance with the provisions of the AIF Regulations. This is in furtherance of SEBI's endeavour to encourage fund managers to incorporate AIFs in an IFSC. In November 2018, SEBI prescribed detailed operating guidelines to regulate AIFs in India's first IFSC set up under Section 18(1) of the Special Economic Zones Act 2005 in Gujarat International Finance Tec-City. These actions are in furtherance of the guidelines prescribed in 2015 to facilitate and regulate the securities market at the IFSC. The operating guidelines allow AIFs in the IFSC to invest through the FVCI, FDI or FPI route. Previously, AIFs in the IFSC were allowed to invest only through the FPI route. In addition, the caps applicable to AIFs (see Section II.iv) will not be applicable to an AIF set up in the IFSC. The guidelines provide global investors a more viable option to set up global funds in the IFSC in the form of an AIF.

Clarification on the appointed date

In view of differing judgements on whether the ‘appointed date’ in schemes of mergers and amalgamations filed under Section 232 of the Companies Act 2013 should be a specified date preceding the sanctioning of the scheme or filing of the certified copy with the registrar of companies (RoC), or thereafter, once the MCA has issued a clarification on the interpretation of appointed date clarifying that companies may choose the appointed date of the merger or amalgamation based on occurrence of an event, which allows such companies to function independently until such event actually materialises. However, in the case of an event-based date being a date subsequent to the date of filing the order with the RoC under Section 232(5), the company shall file an intimation of the same with the Registrar within 30 days of such scheme coming into force. Such appointed date identified under the scheme shall also be deemed to be the acquisition date and date of transfer of control for the purpose of conforming to accounting standards (including Indian Accounting Standard 103, Business Combinations).
**Integrated online reporting of foreign investments and filing of annual returns**

To simplify the reporting process of foreign investments, the RBI released the single master form (SMF) with effect from 1 September 2018. With the implementation of the SMF, the reporting of FDI (which is presently a two-step procedure, namely the submission of an advance remittance form (ARF) and a foreign collaboration – general permission route (FC-GPR) form), has been merged into a single revised FC-GPR. Five forms (FC-GPR, FC-TRS, LLP-I, LLP-II and CN) were available for filing using the SMF. Since 1 September 2018, all new filings for these five form categories must be done using the SMF only. In addition, the RBI has introduced the Foreign Liabilities and Assets Information Reporting System, a web-based reporting portal, via a circular dated 28 June 2019, for the purpose of replacing email-based reporting of foreign liabilities and assets of Indian companies, FDI received by Indian companies, and inward and outward foreign affiliate trade statistics.

**Draft National e-Commerce Policy**

In February 2019, the DPIIT issued the Draft National e-Commerce Policy, which primarily aims to create a conducive regulatory framework for development of the e-commerce sector, empowering domestic entrepreneurs, leveraging access to data, ensuring infrastructure development and stimulating the participation of micro, small and medium-sized enterprises, start-ups and traders in the digital economy. It provides for regulating cross-border data flows while enabling sharing of anonymised community data. Any data not collected in India, any business-to-business data shared between business entities, data flow through software having no personal or community implications and data (excluding data generated by users in India from e-commerce, social media activities or search engines) shared internally by multinational corporations are exempted from cross-border data flow restrictions. In addition, it recognises the ‘network effect’ (greater access to data sources resulting in greater likelihoods of success) in M&A transactions by which e-commerce players such as social medial platforms take over potential competitors early and avoid emergence of competition later. An inter-ministerial panel under the DPIIT will be constituted to address stakeholders’ concerns and provide necessary clarifications on issues related to FDI in e-commerce. The policy is expected to come into effect during 2020 and sufficient time will be provided to stakeholders to adapt the policy prospectively.\(^6^6\)

**SEBI framework for issue of depository receipts**

In October 2019, SEBI introduced a framework for the issue of depository receipts (DRs) pursuant to Section 41 of the Companies Act 2013, the Companies (Global Depository Receipt) Rules 2014 and the Depository Receipts Scheme 2014. In light of the recent RBI and central government notifications amending the definition of permissible jurisdiction and amendments to the Prevention of Money Laundering Act (Maintenance of Records) Rules 2005, it has been clarified that only a company incorporated in India and listed on a recognised stock exchange in India may issue permissible securities and their holders may transfer such securities for the purpose of issuing DRs subject to the compliance of the requirements in

relation to the eligibility, permissible jurisdictions and international exchanges, compliance with extant laws, permissible holder requirements, voting rights and pricing and obligations of the Indian depository, foreign depository and the domestic custodian.

**Insolvency Code**

Following the trend for changes and clarifications, 2019 also witnessed a number of amendments to the Insolvency Code and the Insolvency and Bankruptcy Board of India (IBBI) (Insolvency Resolution Process for Corporate Persons) Regulations 2016 (the CIRP Regulations) thereunder. One of the key amendments to the Insolvency Code included the grant of immunity to an insolvent company and its assets from prosecution for offences committed prior to the insolvency process, provided that such insolvent company has been acquired by a person who is not connected with the management or such offences. In addition, the time period for resolution of cases under the Insolvency Code, including litigations and other judicial process, has been increased from 270 days to 330 days. One of the amendments also provides that a resolution plan could distinguish between financial creditors on the basis of their priority and value of security interest.

Key amendments to the CIRP Regulations in 2019 include:

- a) the resolution applicant must furnish the CoC with a performance security pertaining to the nature of the resolution plan and the business of the corporate debtor;
- b) an authorised representative of a financial creditor will be entitled to cast his or her vote in respect of all financial creditors represented by him or her. Accordingly, the waterfall for payments under the resolution plan has been modified to the effect that the dissenting financial creditors will be paid in priority to the financial creditors who voted in favour of the resolution plan;
- c) corporate restructuring of the corporate debtor (by way of merger, amalgamation and demerger) can now be included in the resolution plan; and
- d) the insolvency professionals and insolvency professional agencies must electronically furnish certain forms to ensure transparency in the corporate insolvency resolution process. Any failure, delay or furnishing of incomplete or incorrect information or records with the form by the insolvency professionals will make them liable for an action under the Insolvency Code by the IBBI.

In addition, the IBBI has notified separate regulations for insolvency resolution processes and bankruptcy proceedings for personal guarantors to the corporate debtors, with effect from 1 December 2019. The regulations on the insolvency resolution process, inter alia, set out the eligibility criteria of the resolution professional, the manner of receipt and verification of claims of creditors, the contents of the repayment plan and the procedure for filing an application for the issuance of a discharge order. Akin to the regulations on the insolvency process, the regulations on the bankruptcy process provide for, inter alia, the eligibility to act as a bankruptcy trustee for the bankruptcy process, the manner of preparation of reports and timeline for submission by the bankruptcy trustee and the manner of realisation of assets of the bankrupt and its distribution. In March 2019, the IBBI also issued an indicative charter of responsibilities of the CoC and resolution professionals for the purpose of clarifying the roles and responsibilities to be discharged by them respectively during the insolvency process.

Apart from the legislative amendments, the Insolvency Code was significantly shaped by verdicts passed by the Supreme Court of India. One of the key developments in the Insolvency Code is the Supreme Court’s decision to uphold the constitutional validity of the
Insolvency Code. The Insolvency Code has faced challenges of unconstitutionality on the basis that it, inter alia, provides primacy to financial creditors over operational creditors. In this context, operational creditors will need to calculate ways in which to secure themselves in the eventuality of default of payments by corporate debtors.

**Key tax proposals under the Finance Bill 2020**

The Finance Bill 2020, presented on 1 February 2020, seeks to give effect to the financial proposals of the central government for the financial year 2020–2021. Some of the key tax proposals announced in the Finance Bill are summarised below.

Any income of a sovereign wealth fund in the nature of dividend, interest or long-term capital gains arising from an investment made by it in India on or before 31 March 2024 and held for at least three years, whether in the form of debt or equity in a company or enterprise carrying on the business of developing or operating and maintaining, or developing, operating and maintaining any infrastructure facility or any other notified business, are proposed to be exempted from tax under the Finance Bill. Such exemption is granted to sovereign wealth funds that fulfil certain conditions, inter alia: (1) the fund is wholly owned and controlled (directly or indirectly) by the government of a foreign country; (2) the fund does not undertake any commercial activity whether within or outside India; (3) the fund is set up and regulated under the law of such foreign country; and (4) assets of the fund vest in the government of such foreign country upon dissolution.

To incentivise offshore funds to set-up their management arm in India, these have been granted exemption from the purview of business connection (so as to avail exemption from income tax in India), subject to fulfilment of certain conditions, inter alia: (1) the aggregate participation or investment in the fund, directly or indirectly, by persons resident in India should not exceed 5 per cent of the corpus of the fund; and (2) if the fund has been established or incorporated in the financial year under review, the corpus of the fund should not be less than 1 billion rupees at the end of a six-month period from the last day of the month of its establishment or incorporation, or at the end of such financial year, whichever is later. Following certain practical difficulties in achieving the objective of such exemptions, the Finance Bill relaxes the aforesaid conditions to the extent that any contribution by an eligible fund manager during the first three years, up to 250 million rupees, will not be included for calculation of aggregate participation or investment in the fund. In addition, if the offshore fund has been established or incorporated in the previous year, the corpus of the fund should not be less than 1 billion rupees at the end of a 12-month period from the last day of the month of its establishment or incorporation.

Another important development proposed by the Finance Bill is to abolish the levy of dividend distribution tax (currently at the rate of 20.56 per cent) on the distribution of dividend. It is proposed to shift the tax burden from the company, mutual fund or business trust to the shareholders or unitholders, through tax deduction at source. To remove the cascading effect on taxation of dividend, income from dividends received from a domestic company by another domestic company will be deducted from the total income of such recipient company, to the extent of dividend distributed by such recipient company one month prior to the return filing date. However, business trusts will continue to enjoy tax-free receipt of dividend from investee companies. Moreover, the Finance Bill proposes to do away with the requirement of listing units of business trusts (i.e., InvITs and REITs) on a recognised stock exchange for the purpose of availing tax incentives.
In an attempt to adopt the principal purpose test\(^{67}\) outlined in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI),\(^{68}\) the Finance Bill proposes to amend the Income Tax Act to empower the Indian government to enter into a double taxation avoidance agreement (DTAA) with another country (for, inter alia, avoidance of double taxation) without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in a DTAA for the indirect benefit of residents of any third country or territory). Upon such amendment, the benefits that can be availed by a taxpayer under a DTAA will be subject to the principle purpose test.

V OUTLOOK

It would appear that 2019 was a blockbuster year for PE dealmaking in India. Legal and policy reforms towards ease of doing business in India reinforced the belief in India of PE/VC investors, SWFs and deep-pocketed strategic investors. However, 2020 will test the maturity and resilience of Indian markets, and the following factors will have a major impact on investing in India throughout the coming year.

\(a\) Global environment: uncertainty and volatility triggered by major political events (United States–China trade war, Brexit, US–Iran ties, the impact of the coronavirus on China’s economy), increases in oil prices, a strong dollar against other currencies and the imposition of new sanctions and trade barriers by nations may keep global investors away from emerging markets in general.

\(b\) Investor outlook: fundamentals for investment in India will remain strong in the long run, with key drivers such as major reforms aimed at cleaning up the economy and improving ease of doing business in India; record levels of dry powder at the disposal of Asia-focused private equity funds; the race for dominance in the e-commerce industry; renewed interest in India’s growth story from very deep-pocketed long-term institutional investors, SWFs and strategic buyers; and the availability of high-quality distressed assets on the auction block.

\(c\) Primary triggers: triggers such as consolidation to strengthen market position; financial deleveraging; monetising of non-core assets; entering new geographies; the faster pace of insolvency proceedings; the great Indian distressed-asset sale supplying assets at attractive valuations across a number of core areas; the increased appetite of investors, SWFs and strategic buyers for control deals, co-investment deals and platform deals are all expected to keep driving dealmaking activity in India in 2020. Technology, e-commerce, real estate, infrastructure, stressed assets, healthcare, financial services, energy and manufacturing are sectors that are expected to continue receiving interest from investors in 2020.

\(d\) The government of India has set a target to raise nearly US$30 billion for financial year 2020–2021 from divestment of nearly 24 central public sector enterprises. This will

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\(^{67}\) The principal purpose test is a test to be used by tax authorities to determine if the primary purpose of making an investment through a jurisdiction has been to obtain a tax benefit, and, if so, establishes that a taxpayer would be denied the benefit of the DTA.

\(^{68}\) India has signed and ratified the MLI, which came into force in India on 1 October 2019. The provisions of the MLI will be applicable to more than 30 of the covered DTAs and will be applied alongside the existing DTAs, thereby modifying their application to implement the anti-base erosion regime.
India

provide an unparalleled opportunity to strategic buyers and consortiums of PE funds and SWFs to snap up some of the crown jewels of the Indian public sector. Not only will divestments provide access to the untapped potential of public sector enterprises but they will also lead to mega billion-dollar deals due to the size and valuation of these heavy-weight assets.

Overall, the deal triggers seen in 2019 are expected to continue to drive both deal values and volumes in 2020.
Ireland

David Widger

I Overview

i Deal activity

Based on figures available from Mergermarket in January 2020, overall mergers and acquisitions in 2019 decreased by less than 1 per cent in volume (from 315 to 314 deals) when compared with mergers and acquisitions in 2018. In line with 2018 trends, deal volume in 2019 was above the 10-year average of 236 deals per annum, following a significant decrease in 2016 due to the uncertainty caused by the decision of the United Kingdom to leave the EU and the outcome of the US general election, which had led to a number of transactions being put on hold or reconsidered. The aggregate deal value in 2019 was approximately 15 per cent higher than it was in 2018 (from approximately €94.658 billion to €109.353 billion). In line with usual trends, the second quarter was a strong quarter for deal activity, with 95 recorded deals; however, deal activity also remained high in the first and third quarters, with 72 and 62 deals, respectively. The continued strength in deal value and volume reflect the continued strong recovery in mergers and acquisition activity involving Irish companies. A steady increase in deal volume is expected in 2020.

The Irish Competition and Consumer Protection Commission (CCPC) received 47 merger notifications in 2019, representing a decrease of approximately 52 per cent from the 98 mergers notified in 2018. This decrease is explained by the increase of the financial threshold at which notification of a merger or acquisition to the CCPC is required, which came into effect on 1 January 2019. In 2019, the most prominent sectors in terms of a sectoral breakdown of notified mergers were the real estate, information and communications and healthcare sectors. Private equity firms were party to 10 merger notifications made in 2019, representing approximately 21 per cent of the total number of notifications made, largely in line with the percentage in 2018 (33 per cent).

The volume of private equity deals increased from 129 in 2018 to 135 in 2019, based on figures available from Mergermarket in January 2020. Deal value (in respect of disclosed consideration for private equity transactions) increased by approximately 222 per cent, from €7.303 billion in 2018 to €23.559 billion in 2019. The figures continue to demonstrate an overall increase in economic activity in Ireland over the past seven years. To place this in context, the disclosed value of private equity buyouts has increased from €448 million in 2012 to approximately €3.233 billion in 2019, while the disclosed value of private equity exits has increased from €40 million in 2012 to approximately €13.281 billion in 2019.

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1 David Widger is a partner at A&L Goodbody.
There were 39 private equity exits during 2019. This is above the previous year’s figures, with 38 exits in 2018 and 20 exits in 2017, but is still a slight decrease from the 42 exits that occurred in 2011.

As Ireland’s economic recovery continues, a significant number of new sponsors have entered the Irish market in recent years because of reduced asset valuations and the lack of domestic operators with access to acquisition finance. Foreign private equity sponsors in 2019 included entities from the United States, the Netherlands and the United Kingdom.

ii Operation of the market

As is the case in the United Kingdom, in Ireland the management of an investee company is normally incentivised to maximise returns for the private equity investor on a successful exit by allowing the management to take an equity stake in the investee company.

Usual equity incentive arrangements used in Ireland consist of the following.

a Shares: normally, non-preference shares in the investee company are subscribed for, for a nominal amount, by the managers who are to be incentivised; those shares then achieve capital appreciation on a successful exit by the private equity investor.

b Ratchet mechanisms: under a ratchet mechanism, continuing key shareholders and management may be given increased or decreased share rights (as the case may be) in the investee company (ratcheted up or ratcheted down) according to an agreed performance formula or with reference to exit valuations achieved by the private equity investor.

c Share options: the relevant investee company (under terms prescribed by the private equity investor) grants options to subscribe for shares in the capital of the investee company. Such options would normally have a vesting period before they can be exercised, thereby ensuring that the option holders are incentivised to drive the investee company’s performance for the required private equity investment period. The options would also normally be subject to good-leaver or bad-leaver provisions.

In addition to equity incentives, it is common for private equity investors to agree non-equity (such as cash) bonus arrangements with key management or employees – again linked to the investee company’s target performance. It is important to structure such bonus payments to Irish residents in a manner that minimises the amount of income tax payable.

As in the United Kingdom, in Ireland the sale process for an investment by a private equity investor in an Irish non-listed company is largely driven by commercial considerations and can be a protracted process.

Ireland operates a merger control system, whereby certain mergers and acquisitions must first be approved by the CCPC (or indeed approved at EU level in certain circumstances) if they result in prescribed turnover thresholds being reached, or relate to particular industry sectors.

The challenges that the Irish economy faced from 2007 for a period of six or seven years, including obtaining funding from risk-averse local banks, led to an increase in the amount of time it typically took to get deals done. Completing due diligence and getting funding in place became more drawn out than was the case before 2007, caused in part by an increasingly risk-averse appetite for investment. However, the pickup in the domestic M&A market in more recent years has seen a return to a more normally functioning, efficient M&A market.
The main documents used in a private equity investment are normally as follows:

1. a sale agreement (between the private equity investment vehicle and the relevant selling shareholders where a shareholder is exiting the investee company) or, more usually, a subscription and shareholders’ agreement (between the private equity purchase vehicle and the continuing shareholders and other key management);

2. a loan note instrument if the private equity investor is also subscribing for loan notes in the investee company. Private equity investors investing in Irish investee companies commonly invest through a combination of equity (in the form of ordinary and preference shares) and loan notes;

3. the investee company’s articles of association, which set out the rights attaching to the various classes of shares in the capital of the investee company, including the private equity investor’s equity; these normally include, inter alia, dividend rights, liquidation preference rights, anti-dilution rights, drag-along rights and tag-along rights;

4. any employment or service agreements for the senior management of the investee company;

5. the tax deed from the shareholders or investee company, in favour of the private equity purchase vehicle providing an indemnity in respect of pre-investment tax liabilities of the investee company;

6. share option arrangements; and

7. any finance documentation where the private equity investor is raising bank debt to finance investment.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

A private equity sponsor will have two distinct layers of structure and documentation in place to control private equity investments in investee companies.

The first layer details the structure to be used by the private equity sponsor to raise, hold, manage, invest and distribute the private equity funding and the proceeds of investment, as between the private equity sponsor and the private equity investors who invest in its fund. Most Irish private equity funds are established as unregulated limited partnerships under the Irish Limited Partnership Act 1907.

The second structure layer sets out how the private equity structure established and controlled by the private equity sponsor (as stated, normally a limited partnership – the private equity investor) actually invests the private equity funds raised by the limited partnership in target investee companies, and how the private equity investor manages, controls and eventually realises those investments.

Establishment of private equity sponsors’ control over the private equity fund structure

Fund structures used by private equity sponsors in Ireland to raise, hold and make investments in target investee companies can be unregulated limited partnerships, regulated funds or investment limited partnerships, general partnerships and special purpose vehicles (which are either Irish private limited liability companies or public limited liability companies, under the Irish Companies Act 2014 (the Irish Companies Act)). Most Irish private equity funds are established as limited partnerships, which are governed by a partnership agreement.
**Limited partnerships**

Every limited partnership must consist of at least one general partner (GP) and at least one limited partner (LP), and must not contain more than 20 partners (or 50 where the limited partnership “is formed for the purpose of the provision of investment and loan finance and ancillary facilities and services to persons engaged in industrial or commercial activities”).

The private equity sponsor controls the GP and, either through the GP or a separate management company, manages the investment activities of the limited partnership. If there is to be a separate management company, that management company contracts directly with the partnership to provide that service.

The GP has unlimited liability with regard to third parties. For this reason, many private equity sponsors use a limited liability vehicle to act as GP.

Normally, private equity investors who wish to invest through the private equity sponsor structure will be LPs in the limited partnership.

A limited partnership is not, and does not create, a separate legal entity; they have become popular in tax-driven financings and structures because they are tax-transparent.

A body corporate may be an LP or a GP, but a partnership in itself cannot be an LP or a GP in a limited partnership. Limited partnerships, therefore, allow persons and entities to be involved in a partnership purely as investors, and without the risk of unlimited liability to creditors.

As noted above, a private equity fund structured as a limited partnership is governed by the terms of the partnership agreement establishing it. The private equity sponsor will normally ensure that the limited partnership agreement contains provisions adequately compensating the private equity sponsor, as GP or manager, for its efforts, and granting it sufficient power to manage the limited partnership’s activities and investments in the manner it deems necessary to maximise returns. The limited partnership agreement will also set out the term of the life of the partnership.

**Regulated funds or investment limited partnerships**

These are rarely used by private equity sponsors as they are regulated by the Central Bank of Ireland (the Irish Central Bank) and are subject to certain restrictions, including investment and borrowing limits (although in the case of funds targeted at professional investors, institutions and high-net-worth individuals, derogations are available from many of the restrictions), requirements as to the suitability of the private equity sponsor, and the fact that independent custodians and administrators must be appointed.

**Irish limited liability companies**

Irish limited liability companies established under the Irish Companies Act are occasionally used to obtain the benefit of limited liability, as the liability of each member, including the private equity sponsor, is (in the absence of fraud, etc.) limited to the amount of issued share capital subscribed for by each such member in that company. Limited partnerships tend to be used as fund structures more than Irish companies because of tax and company law issues arising on extracting value from Irish companies, and because of the account-filing obligations that arise.

While unlimited liability companies do exist under the Irish Companies Act, they tend to be rarely used as private equity fund vehicles.

The private equity sponsor, when utilising an Irish company as a private equity fund vehicle, would establish control over the relevant company through a comprehensive
subscription and shareholders’ agreement, setting out the terms upon which the private equity sponsor and each private equity investor will invest in the company (through equity and debt), and their respective information, control and liquidation preference rights on dissolution of the company.

Each Irish company must have a minimum of one European Economic Area (EEA) resident director (or alternatively arrange for an insurance bond to be put in place). In practice, at least two Irish-resident directors are usually appointed to ensure Irish tax residency for the relevant company by placing central management and control in Ireland. The test for central management and control is not defined in Irish legislation, and the meaning of central management and control is based on a body of case law.

**Irish general partnerships**

An Irish general partnership is one in which all the partners (including the investors) have joint and several liability for the debts and obligations of the partnership to third parties. Again, an Irish general partnership is not, and does not create, a separate legal entity, and is also tax-transparent.

Irish limited partnerships, where the LPs have limited liability, are, therefore, normally preferred over general partnerships as ‘partnership’ fund structures.

The manner in which an Irish general partnership fund is structured, controlled and can make, realise and distribute the proceeds of investments (including, for example, provisions dealing with investment term and policy) is also prescribed by the terms of the partnership agreement under which it is established.

**Establishment of private equity sponsors’ control over investments**

The principal way in which the private equity investor will exercise control over each relevant investee is through the subscription and shareholders’ agreement.

The extent of the private equity investor’s control over an investee is a matter of commercial agreement between the parties (which include the private equity investor on one side and the investee company, its other shareholders and relevant management on the other). A well-structured investment agreement would normally provide the private equity investor with:

- leverage of warranties, indemnities or non-compete covenants;
- board representation and quorum rights;
- information and reporting rights;
- veto rights;
- step-in rights;
- preferred equity share rights;
- pre-emption rights; and
- transfer restrictions.

**Key structuring considerations for sponsors domiciled outside the jurisdiction**

Any foreign private equity sponsor wishing to operate or establish a private equity fund in Ireland will require specific local and Irish tax advice on the structuring of such a fund.

Foreign persons and entities are entitled to hold shares in Irish companies. Each Irish company must have a minimum of one EEA-resident director (or alternatively arrange for an insurance bond to be put in place), and if the Irish company is to be Irish tax-resident, in practice at least two Irish-resident directors are usually appointed.
The Irish Companies Registration Office will need to be satisfied that the limited partnership is carrying on business in Ireland before it will accept its registration, or the registration of a related business name for the partnership. Logistically, the foreign GP will have to be able to show that it is running the limited partnership business in Ireland, and this may involve it having an office and personnel in Ireland for that purpose.

If a foreign private equity sponsor wishes to establish an Irish limited partnership, and to act as the GP of that limited partnership, it is usual for that foreign GP to register as having established a ‘branch’ in Ireland.

Foreign companies with a branch in Ireland are required to file a balance sheet, profit and loss account, directors’ report and auditor’s report with the Companies Registration Office in Ireland, and if the company is a holding company, group accounts should be furnished.

ii Fiduciary duties and liabilities

The private equity sponsor must first understand what, if any, fiduciary duties it owes private equity investors investing through the private equity fund it has established in Ireland, and second understand the fiduciary duties that the fund itself owes other shareholders in the portfolio investee companies the private equity investor invests in.

No fiduciary duties as such exist between shareholders under Irish law – unlike directors, who are obliged not to act in breach of their fiduciary duties to the company of which they are a director. Further, as a general principle, shareholders may also vote as they please; the right to vote being a personal right of the shareholders, they are generally free to act in their own interests and to exercise their own judgement as to how they vote.

Private equity sponsors’ representatives on a portfolio investee company’s board (nominee directors) owe the same duties to the relevant investee company as any other director. Nominee directors should bear in mind that they, like all directors, are subject to the obligations contained in the Irish Companies Act, and elsewhere in respect of listed and regulated entities, with regard to directors and disclosure of conflicts of interest.

Nominee directors also owe fiduciary duties to creditors, where a company is insolvent or in a ‘zone of insolvency’; and employees and shareholders, to the extent the Irish courts now view the interests of a company’s employees and shareholders as interests of the company itself.

The Irish Companies Act, which commenced on 1 June 2015, consolidated and introduced certain reforms to pre-existing Irish company legislation, including the codification of directors’ fiduciary duties and directors’ liability to account to the company for gains made and to indemnify the company for losses caused as a result of their breach of duty.

There are numerous situations where a company director can face personal liability other than for breach of his or her fiduciary duties as a director, and can also face heavy fines and sometimes imprisonment for breaches of the requirements of various statutes, such as those relating to company, environmental, and health and safety law. Shadow directors are also included in the definition of director for many offences.

In the context of insolvency, directors may also face liability where they make an inaccurate declaration required to allow a private company to give financial assistance for the purchase of its own shares (an act ordinarily prohibited under the Irish Companies Act), engage in ‘fraudulent’ or ‘reckless’ trading, misapply company assets, make an incorrect declaration of solvency in the context of a voluntary liquidation or buy shares in a company’s holding company in certain circumstances.
On insolvency of a company, a director may also face ‘restriction’ or ‘disqualification’ for up to five years or such other period as the courts think fit.

Under the Limited Partnership Act 1907, the GP of a limited partnership is akin to a member of an ordinary partnership and is liable for all debts and obligations of the partnership. The GP (or manager) controls the business of the partnership and so is involved in its day-to-day management. To this effect, the GP is authorised to bind the partnership in relation to partnership business and to negotiate and execute documents, and he or she is also liable, without limitation, for the debts of the partnership.

Irish law continues to support the fundamental principle that a company possesses a separate legal identity from its shareholders. A private equity investor shareholder, no matter how great the extent of its shareholding or of the control exercised by it over the board of directors in an investee company, cannot normally be made liable for the debts of that investee company.

In very exceptional circumstances, usually involving some level of wrongdoing and where justice requires it, a court will set aside this principle and ‘pierce the corporate veil’. The essential question in any case involving a piercing of the corporate veil is whether the purpose for which the distinction between the private equity investor shareholder and the investee company exists is real or merely represents a diversion of liability away from the party upon whom it more correctly rests. It would, however, be highly unlikely for a court to pierce the corporate veil and attribute the liability of an investee company to its private equity investor shareholder.

Apart from the common law carve-outs where Irish courts are willing to pierce the corporate veil, there is also statutory provision under Irish law for the imposition of ‘related company’ liability on two separate Irish companies. Section 599 of the Irish Companies Act allows a court to make an order requiring one company to contribute to the debts and liabilities of another insolvent related company in circumstances where the court considers it just and equitable to make such an order.

In reality, it is difficult to foresee in the event of a claim against any investee company how the relevant private equity investor would be held responsible for the resulting liabilities of the investee company.

In terms of raising finance to invest in investee companies, the use of a limited partnership structure, as opposed to a limited liability corporate structure, typically has no material adverse consequences or implications for lenders to that structure, nor does it affect the ability of the borrower (i.e., the limited partnership) to repay its financial obligations to a lender under the relevant facility agreement, to create security in favour of the lender or to carry out and perform its obligations under the project documents.

From a lender’s point of view, any differences between lending to a limited partnership and to a limited liability company are more of a structural nature than anything else.

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2 A company is deemed to be related to another company: (1) where it is its holding company or subsidiary; (2) where it or its other group companies own more than 50 per cent of the share capital; (3) where its own members own more than 50 per cent of the share capital; (4) where it is entitled to exercise or control the exercise of more than 50 per cent of the voting power at any general meeting of the company; (5) where there is another company to which both companies are related; or (6) where the businesses of the companies have been carried on in such a way that the separate business of each company is not readily identifiable. (This last proviso does not, however, affect the general principle that group companies are recognised to be separate legal entities even where they are interrelated and interact on a day-to-day basis. For Section 140 to be invoked, something beyond normal group trading is required.)
The enforcement remedies available to lenders in respect of a limited partnership will be as set out in the relevant debenture, and these normally include either appointing a receiver to the assets of the partnership, or the lender enforcing their security as mortgagees in possession.

Where a receiver might be appointed to the partnership, the receiver would look to the assets of the partnership, which would mean looking to the assets held by the GP on the limited partnership’s behalf. It is important to remember that the liability (in the context of the partnership) of the GP is unlimited (for this reason, a lot of private equity sponsors utilise a limited liability company to act as GP), and so lenders are entitled to seek recovery against the GP for everything. Nevertheless, if there were to be a shortfall, as well as having recourse to the GP, the receiver would be entitled to look to the capital contribution made by the limited partners; the liability of each LP is limited to its capital contribution.

Normally, a private equity investor investing in an investee company will have agreed and incorporated exit rights into the investment agreement signed with the other shareholders of the investee company. Such rights normally allow the private equity investor to instigate, or compel, a process that will lead to a sale or initial public offering (IPO) of the entire issued share capital of the investee company after a certain period following its investment (frequently, four to six years).

An exit by a private equity investor from a portfolio investee company will be determined by the financial circumstances of the relevant investee company and the prevailing economic conditions affecting the market in which it operates, or the financial markets generally.

Where the investment in an investee company has been successful, the most common forms of exit currently are either trade sales, or secondary sales to other venture capital or private equity funds. Although IPOs have, in the past, tended to achieve higher exit values for investors, they are not common at present in Ireland.

Where the investment has not been successful, the most common forms of exit are either the sale of the investee company to another investor or to the investee company’s management, or the liquidation of the investee company. Sale is normally more attractive to a private equity investor, as it allows it to recover some of its investment while avoiding the exposures and complexities involved in an insolvent liquidation.

III  YEAR IN REVIEW

i  Recent deal activity

2019 marked an increase in private equity deals in Ireland as the economic conditions in the market continued to stabilise. Based on figures available from Mergermarket in January 2020 (in respect of disclosed consideration for private equity transactions), the aggregate private equity deal value (comprising both buyouts and exits) in Ireland in 2019 rose above the 2018 figures by approximately 222 per cent, to €23.559 billion, comprising 135 transactions.

In respect of overall merger and acquisitions, the total deals recorded during the first quarter in 2019 were lower than the 2018 figures, with 72 deals at an aggregate value of €3.517 billion. Noteworthy deals recorded during the quarter included the acquisition by STAR Capital Partnership LLP through Star Throne Midco DAC of the entire issued share capital of ASL Aviation Holdings DAC for an estimated €208 million; the agreement by Epiris GP Limited to acquire IFG Group plc for €208 million; and 3i Group plc’s acquisition of Ireland-based Direct Route (Fermoy) Holdings Limited for €105 million.

Deal value (around €88.736 billion) and volume (95 deals) in the second quarter were higher than in the same period in 2018; however, it should be remembered that the
considerable increase in deal value in this quarter both in 2018 and 2019 was due largely to a small number of significantly high-value transactions, namely, in 2019, the acquisition by drug manufacturer AbbVie Inc of Ireland-based Allergan plc for a reported value of €75.768 billion (the highest-value M&A deal in Ireland in 2019); Charterhouse Capital Partners LLP’s acquisition of Tarsus Group plc for €717 million; and the acquisition by TPG Capital LP of a minority stake in Kaseya Limited for €447 million.

In the third quarter of 2019, a total of 62 deals were recorded, at an aggregate deal value of approximately €5.354 billion, compared with 81 deals of approximately €15.645 billion in 2018. Significant transactions recorded during the quarter included the joint venture of Aptiv plc and Hyundai Motor Group valued at approximately €1.819 billion; Henderson Park Capital’s agreement to acquire Irish real estate investment trust Green REIT Plc for €1.551 billion; and the acquisition by global investment firm Avenue Capital Group of a stake in Castlehaven Finance for approximately €250 million.

Eighty-five deals were recorded in the final three months of 2019, with an aggregate deal value of €11.746 billion, representing an increase in the volume recorded during the same period in 2018. EML Payments’ acquisition of Prepaid Financial Service (Ireland) Limited for a reported value of €263 million was one of the stand-out deals reported.

ii Financing

Private equity transactions are usually structured with a combination of debt and equity, the proportions of each being driven by market conditions and the relative cost and availability of debt. Recent transactions tend to have much lower debt multiples than would have been the case in the past. Where private equity investors can raise debt, that debt now tends to be funded by a number of different banks as the banks are increasingly conscious of the need to minimise risk exposure.

As business confidence returned to the Irish market, recent years saw an increase in the number of Irish companies tapping the equity capital markets, both in Ireland and overseas, such as Cairn Homes, Malin Corporation, Hibernia REIT, Dalata, Glenveagh Properties and AIB.

There was one IPO transaction in 2019, the IPO of Uniphar, an Irish-incorporated pharmaceutical company, on London’s Alternative Investment Market and Euronext Dublin (formerly the Irish Stock Exchange) for approximately €150 million. Uniphar is an Irish pharmaceutical wholesale and retailing group and was formed in 1994 through the merger of United Pharmacists Co-op and Allied Pharmaceutical Distributors.

In the property sector in 2018, the housing and apartment developer Glenveagh Properties (which took a primary listing on the Irish and London Stock Exchange in October 2017 and raised approximately €550 million from investors) raised a further €215 million in July 2018 by way of a share sale.

A noteworthy transaction in 2017 was the completion of AIB’s IPO on the Irish Stock Exchange. Raising approximately €3 billion for the state’s 25 per cent stake from Irish and international investors, the listing represented the largest IPO in Europe in 2017.

Funding debt is generally a mixture of senior facility, mezzanine, working capital or other revolving facilities, and some asset finance, if appropriate. There also appears to be an increasing number of private equity financings that include high-yield instruments that are convertible into equity in the event of any default on the part of the promoters seeking the private equity co-investment.
Irish private equity funds typically receive funds from a variety of financial institutions, pension funds, government agencies, quasi-state bodies, overseas development funds with a particular geopolitical interest in Ireland, corporate investors and private high-net-worth individuals. Foreign sponsors and government-funded private equity funds have played an increasingly important role in Irish private equity transactions, as funding from financial institutions (and in particular Irish financial institutions) decreased dramatically as a result of the financial crisis and has only recently begun to return towards previous levels.

Most private equity funds established in Ireland continue to have a term of 10 years, with the possibility of extending that term to allow a greater period for liquidating the fund’s interests in all portfolio investee companies. Typically, funds have an initial investment period of three to five years to source and invest in new companies. Following this initial investment period, the terms of the fund generally restrict its purpose to managing and making follow-on investments in existing portfolio investee companies.

Generally, private equity funds look for returns of between 30 and 40 per cent per annum by way of capital gain.

As noted above, most private equity funds operating in Ireland invest in investee companies by subscribing for preferred equity in the capital of the investee company. Occasionally they take a mix of equity and debt, in the form of loan notes of the investee company (which may also be convertible into equity). The preferred equity rights generally include a combination of liquidation preference rights, veto rights over prescribed actions by the investee company and its management, and anti-dilution protections.

Preference shares are also generally convertible into ordinary shares at the discretion of the private equity investor, and automatically convert on the occurrence of certain agreed exit events; for example, an IPO at a pre-agreed minimum valuation of the investee company.

In certain circumstances (e.g., where the investee company requires short-term bridging finance), private equity funds may also lend money, either by way of a straight loan or convertible security, to investee companies.

iii Key terms of recent control transactions

**AbbVie/Allergan Plc**

AbbVie, an American publicly traded biopharmaceutical company agreed to acquire Allergan plc, an Ireland-based pharmaceutical company, for €75.568 billion.

**Henderson Park Capital**

Henderson Park Capital, a UK-based property company agreed to acquire Green REIT limited, an Ireland-based real estate investment trust, for €1.551 billion.

**Charterhouse Capital Partners LLP**

Charterhouse Capital Partners LLP, a UK-based private equity investment firm agreed to acquire Tarsus Group plc, an international media company, for a cash consideration of €717 million.

iv Exits

Recent financial challenges have eased slightly, leading to an increase in the number of recent private equity exits in Ireland. The average value of private equity exits in 2019 (based on publicly disclosed deal values on Mergermarket) was approximately €340.5 million. Where
exits are occurring, they are being driven either by a need on the part of the private equity sponsor and its co-investors to deleverage, or are taking place in Ireland's buoyant technology sector. Recent notable exits include the following.

**The Stars Group Inc**

Flutter Entertainment plc, an Ireland-based bookmaking holding company publicly listed on the London Stock Exchange, agreed to acquire The Stars Group Inc, a Canada-based gaming and online gambling company, through an all-share combination pursuant to a plan of arrangement under the Business Corporations Act (Ontario) for €9.507 billion.

**Acuris**

Ion Investment Group, an Ireland-based holding company, acquired a majority stake in Acuris, a financial news and data firm from BC Partners, one of the largest European private equity groups that specialises in buyouts and acquisitions, for €1.3 billion.

**Ranir Global Holdings LLC**

Perrigo Company plc, a publicly listed Ireland-based pharmaceutical company, acquired Ranir Global Holdings LLC, one of the largest private oral care companies globally, for a cash consideration of approximately €669 million.

### IV REGULATORY DEVELOPMENTS

The basic framework of Irish funds law and regulation applies equally to private equity funds and other funds.

The Irish Central Bank regulates those conducting private equity activities in Ireland, that is, generally the managers and advisers and not the fund itself. Depending on the fund's structure, other rules and regulations may apply.

For instance, alternative investment funds (AIFs) are now subject to the EU Alternative Investment Funds Managers Directive, which is given effect in Ireland by the European Union (Alternative Investment Fund Managers) Regulations 2013 (AIFMD). The AIFMD applies to AIFs that acquire control of EU-based listed or non-listed companies and imposes asset-stripping restrictions and disclosure obligations on AIF managers. The asset-stripping restrictions require AIF managers to use their best efforts to prevent, for a period of 24 months following the acquisition, any reduction in capital, any share redemption, any distribution or share buy-back in circumstances where the net assets of the company fall below its issued share capital and non-distributable reserves, and any distribution to shareholders greater than available profits. The disclosure obligations require managers of AIFs having a shareholding in a non-listed EU company to inform the company's local regulator of certain reductions in its shareholding, and to provide certain information to the company, other shareholders and the local regulator in the event that the AIF acquires control of the company. The restrictions imposed by the AIFMD do not apply to small and medium-sized enterprises, or to special purpose real estate companies.

Typically, where the private equity fund is structured as an unregulated limited partnership, no licences are required unless the fund is providing certain regulated investment services.
A private equity sponsor providing regulated services in Ireland must be appropriately authorised by the Irish Central Bank or by a competent authority in another EEA Member State. If authorised in another EEA Member State, the entity must passport that authorisation into Ireland. Certain exemptions do, however, apply to the requirement to be authorised.

In the context of private equity transactions, regulated services would include the provision of investment advice, the reception and transmission of orders and the execution of orders in financial instruments.

If an authorisation were required in Ireland, it would be necessary for the private equity sponsor providing the regulated services to submit an application form with supporting documentation (including a programme of activity) to the Irish Central Bank. Directors, designated persons and senior managers of the relevant fund would also be subject to the Irish Central Bank’s ‘Fitness and Probity’ regime.

In certain circumstances, where facilities for participation by the public in an offering are provided, Irish Central Bank approval for the offering will also be required.

If the fund is structured as a regulated investment fund or a regulated investment limited partnership, approvals and authorisations must be obtained from the Irish Central Bank.

It is possible to set up regulated investment funds engaging in private equity investments; these are structured as unit trusts or investment companies. It is also possible to set up regulated investment limited partnerships.

It is also necessary for any partnership that has a place of business in Ireland, and carries on business under a name that does not consist of the true surnames of all partners who are individuals and the corporate names of all partners that are bodies corporate without any addition, to register the use of the name (by all the partners) under which it carries on business with the Irish Companies Registration Office.

The new Market Abuse Regime, which consists of the Market Abuse Regulation and the Market Abuse Directive on criminal sanctions for market abuse, became applicable in Ireland and across the European Union on 3 July 2016. The Irish Central Bank is the single administrative competent authority for the purposes of Irish market abuse law.

The Fifth Anti-Money Laundering Directive is due to be transposed into Irish law during the course of 2020. The Fourth Anti-Money Laundering Directive, currently fully transposed in Ireland, requires that certain Irish corporate entities must take ‘all reasonable steps’ to obtain and hold ‘adequate, accurate and current’ information in respect of their beneficial owners, and construct and keep an up-to-date beneficial ownership register. The new Directive allows public access to certain information held in the register of beneficial ownership of companies operating within the EU. This public register will be interconnected on the EU level to facilitate cross-border cooperation and access to information by regulators and financial intelligence units. Beneficial owners, for the purpose of these regulations, are natural persons who ultimately own or control the entity through direct or indirect ownership of a sufficient percentage of the shares or voting rights in that entity or through control by other means. A sixth revision of the Anti-Money Laundering Directive came into effect on 12 November 2018, on an EU-wide basis, and must be transposed by Member States by 3 December 2020.

The Criminal Justice (Corruption Offences) Act 2017 was enacted in July 2018, as part of a broader package of measures to tackle white-collar crime in Ireland. The legislation modernises Ireland’s existing anti-bribery and corruption laws and introduces a number of new offences and increased penalties.
The Markets in Financial Instruments Directive (MiFID) II Regulations, transposing the MiFID II Directive into Irish law, were signed into law on 10 August 2017 and published by the Department of Finance on 15 August 2017. The Regulations have a broad scope, impacting organisational, conduct of business and transparency requirements, and will affect private equity firms regardless of whether or not they are MiFID firms. The Regulations entered into effect on 3 January 2018.

V OUTLOOK

Private equity activity, which slowed significantly in 2016 after a number of years of consistent improvement in terms of disclosed deal value and volume, has stabilised in 2018 and 2019 and is likely to continue increasing steadily in 2020. The steady Irish economic recovery has created a far more attractive investment environment, but global economic and political uncertainty and the fallout from the Brexit vote continue to present risks to the market.

One evolving feature is the increase in secondary sales by the purchasers of Irish businesses and assets via distressed debt sales during or immediately following the economic crisis. Many of these purchasers were private equity and hedge funds (a significant proportion of which are US-based) and a number have already sold on the acquired debt books or may look to do so during 2020.

The recovery of Ireland’s technology, media and telecoms (TMT), agri-food, pharmaceutical, and medical and biotech sectors, presents significant potential opportunities for private equity in the future. There is strong domestic and international interest in these assets, and any ensuing sales processes are likely to attract a multitude of interested suitors.

It appears that the financing difficulties Ireland has faced in recent years have eased significantly in the past four years, and this should see a stabilisation or increase in deal flows and deal values, provided global macroeconomic conditions are favourable. If market equity activity improves in 2020, increasing opportunities are available for companies that can access private equity funding to grow their business through real value-for-money acquisitions.

There is an increasing perception of Ireland as a place where private equity investors can obtain a good deal of value for their investments, and this continued convergence of buyer and seller expectations as regards company valuations should facilitate a continuing flow of private equity transactions in Ireland in 2020.

Although bank funding has increased over the past year and is expected to continue to increase in 2020, international private equity providers are also expected to play an important role in Irish M&A activity in 2020 as they actively seek to take advantage of Irish value opportunities.

The mid-market sector is also expected to see increased activity and a return of domestic buyers, sometimes funded by private equity rather than traditional bank debt.

For 2020, transactions are likely to be structured with a combination of bank-leveraged debt and funding from private equity providers who will lead other forms of funding such as mezzanine finance, asset finance and vendor loan notes.

The sectors that have seen the most activity in the past four years – financial services, agri-food, TMT and pharmaceutical and life sciences – are likely to continue to do so in 2020.
I OVERVIEW

i Deal activity

Despite the uncertainty in the European (and Italian, in particular) economic and political environment, private equity (PE) activity in the first half-year of 2018 (the most recent statistics available at the time of writing) has been positive, with the one of the strongest Q1s for Italian PE deal activity in terms of both deal numbers and value. Deal activity in 2018 has maintained the upward trend that started in 2016 and 2017.

According to the data made available in the Italian Private Equity Venture Capital and Private Debt Association (AIFI) and PricewaterhouseCoopers report ‘The Italian Private Equity and Venture Capital Market: 1 Semester 2018’, in the first half of 2018, the value of investment amounts stood at €2.857 billion (up 49 per cent compared to the first half-year of 2017) with 160 deals (up 15 per cent compared to the first half-year of 2017).

Investments in Italy have been characterised by a prevalence of investments in the industrial (30 per cent of deals), consumer (27 per cent) and financial (25 per cent) sectors. Investments in technology registered a decrease compared to 2016 and 2017. More specifically, the industrials and consumer goods sectors made up more than half of all deals, whereas in the past technology was the most dominant sector by some margin. The large deals in financial services can be explained by the crisis of certain Italian banks and the acquisition of non-performing loan portfolios by PE sponsors. PE investments are mainly concentrated in the north of Italy, and, in particular, in Lombardia (44.7 per cent), Veneto (10 per cent) and Emilia-Romagna (8.7 per cent). Only a few investments have been made in the south of Italy (two deals in Puglia, one in Campania and one in Basilicata).

Some of the largest deals in 2018 indicate the level of interest in the traditional Italian strongholds. Peninsula and special purpose vehicle Space4 acquired Italian bottle-sealing manufacturer Guala Closures. Bain Capital acquired Ardian-owned Italmatch, a leading innovative chemical group for €700 million. Sun Hydraulics acquired Faster, a manufacturer of quick-release hydraulic couplings.

In terms of types of investments by PE sponsors, the interest in majority investments increased compared to the previous half-year (up from 67.66 per cent to 73.4 per cent). Investments providing for the acquisition of a minority interest registered a substantial decrease, namely down from 18.4 per cent in the second half-year of 2017 to 14.3 per cent in 2018.

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1 Adele Zito is an associate at BonelliErede. The information in this chapter was accurate as at April 2019.
In the first half-year of 2018, fundraising amounts totalled €1.852 billion (as against €1.195 billion in the same period in 2017), of which €1.289 billion was raised by private independent entities (compared to €453 million raised by independent entities in 2017). More specifically, fundraising was largely the concern of individual investors and family offices (17.3 per cent), pensions funds (15.6 per cent), banks (14.4 per cent) and insurance companies (14.2 per cent).

As far as exit transactions are concerned, in the first half-year of 2018, the value of exit transactions decreased compared to the previous half-year, amounting to €1.109 billion (down 10 per cent compared to the first half-year of 2017), with 59 deals (down 24 per cent compared to the first half-year of 2017).

ii Operation of the market

Management equity incentive arrangements

In 2018, management equity incentive plans for managers or key employees benefitted from the introduction of a relevant piece of legislation, namely Article 60 of Legislative Decree No. 50/2017.

This provision sets out a presumption of law by virtue of which the carried interest (namely the proceeds that key employees or directors receive from direct or indirect participation in companies) is subject to taxation as financial income (with a much lower rate, on average, than that applicable to employment income) if the underlying financial or participative instruments held in the company by the manager meet the following requisites:

a the total investment commitment of the relevant employees or directors triggers an actual disbursement of at least 1 per cent of the net assets of the company;

b the vesting of the instruments occurs only after the shareholders of the company hit a pre-determined hurdle rate (i.e., a minimum return rate) or, in the event of a change of control, on the condition that ordinary shareholders have realised a return at least equal to the invested capital plus the aforementioned hurdle rate; and

c the instruments are held by the managers concerned (or, in the event of death, by the heirs) for a period of no less than five years or, if prior to the five-year period, until the date on which a change of control takes place.

Standard sale process

Despite there being no mandatory process, competitive sales in Italy are usually structured in recurring phases.

The initial effort is generally made by the management of a target company or its shareholders with the help of a financial adviser. They put together a ‘teaser’ and, for those who show interest and sign a non-disclosure agreement, an information memorandum. Typically, management presentations follow and the potential purchasers are asked to submit non-binding offers. Due diligence checks usually take place before binding offers are submitted (sometimes, also second-round binding offers are provided) and are often preceded by vendor due diligence reports. Transaction documents (which are usually based on formats put together by the sellers) are often attached to the offers made by the potential acquirers.

The duration of a sale process may depend on a number of different factors, including the level of competition, necessity of authorisations for execution of the transactions (clearance from antitrust authorities, bank waivers, etc.) and the regulatory background to the sale.

The duration of competitive processes for medium-size acquisitions (whose closing occurs after signing) may range from two to six months depending on regulatory approvals.
II LEGAL FRAMEWORK
i Acquisition of control and minority interests

Acquisitions of control and minority interests are usually made by PE sponsors through special purpose companies. In Italy, the two most common types of companies are the joint-stock company (SpA) and the limited liability company (Srl).

Generally, special purpose vehicles are SpAs since this type of company enjoys characteristics that are generally more appealing to investors, such as the option to issue bonds or to have different classes of shares with different rights. However, Srls have lower minimum capital requirements and are generally more flexible than SpAs.

Another main difference between SpAs and Srls concerns corporate capital. The SpA’s corporate capital is divided into shares and represented by financial instruments that can be listed and negotiated in regulated markets, whereas the Srl’s corporate capital is represented by a quota with no unitary value.

In this context, however, note that in 2017 the Italian legislature significantly amended this structure, introducing certain rules for Srls that were traditionally applicable only to SpAs. In detail, Law Decree No. 50 of 24 April 2017 and Legislative Decree No. 129 of 3 August 2017 established that small and medium-sized enterprises (SMEs) organised as Srls may derogate from the traditional corporate model for all Srls provided for in the Italian Civil Code. These companies (SMEs or SME Srls) are medium-sized and small Srls within the meaning of the Commission Recommendation of 6 May 2003, namely enterprises that employ fewer than 250 persons and that have an annual turnover not exceeding €50 million, or an annual balance sheet total not exceeding €43 million.

Different classes of quotas

According to the new rules, the by-laws of the SMEs may provide for ‘classes’ of quotas with different rights and, within the limits imposed by law, may freely determine the content of the various classes of quotas, in derogation of the provisions of Article 2468, Paragraphs 2 and 3, of the Italian Civil Code.

For example, it is now possible to have classes of quota holders without the right to vote at the general meetings or whose voting right is limited by specific conditions or on certain matters. Also, the by-laws may provide for classes of quota holders with voting rights not proportional to the percentage of corporate capital owned.

Public offering of quotas of SME Srls

The quotas of SME Srls can be the object of a public offering of financial products, including through crowdfunding portals. This option was already available to innovative small and medium-sized companies under the previous legislative framework; however, the 2017 reform extended this option to include SME Srls.

The SME Srls whose quotas are the object of a public offering can opt to dematerialise their quotas, thus derogating from the traditional system of quota transfers.

Operations on quotas

According to Article 2474 of the Italian Civil Code, traditional Srls may not grant loans or give guarantees for the purchase or subscription of their own quotas.
As an exception, SME Srls – in the context of the implementation of incentive plans that provide for the assignment of interests to employees, collaborators or members of the administrative body or service providers – are now entitled to grant loans or give guarantees for the purchase or subscription of their own quotas.

ii Shareholders’ agreements

Usually PE funds effect the corporate governance of the target companies in which they invest through shareholders’ agreements.

The duration of the agreement is a key provision in such agreements, as it represents the reconciliation between different demands of corporate law: on one hand, stabilising the ownership of a company and, on the other hand, preserving the freedom of economic initiative of the shareholders, who may terminate the agreement.

Article 2341 bis of the Italian Civil Code provides that shareholders’ agreements (specifically those agreements that, to stabilise the company’s ownership structure or governance, (1) have as their object the exercise of the right of to vote, (2) set limits on the transfer of related shares, or (3) have as their object or effect the joint exercise of a dominant influence on a certain company) may not provide for a duration exceeding five years, although shareholders’ agreements may be voluntarily renewed by the parties upon expiration. If the shareholders’ agreement does not provide for a term, each party may withdraw at any time following 180 days’ notice.

It has been debated among practitioners whether an automatic renewal provision in the shareholders’ agreement (which would, therefore, entail the renewal of the agreement for a term in excess of five years in the event that no party notifies the other of its intention not to renew the agreement) triggers a violation of Article 2341 bis or not. However, case law had not taken any specific position on this until, in a recent case law decision, the Court of Appeal of Brescia opted for the voidance of the clause of a shareholders’ agreement that provided for tacit and automatic renewal of the fixed-term shareholders’ agreement in the event that the relevant shareholder failed to communicate the termination of the agreement with one year’s advance notice. According to the Court, this provision circumvented the mandatory five-year duration limit set out by Article 2341 bis of the Italian Civil Code. It seems, however, that the Court might have opted for the voidance of the provision not because of the existence of a tacit renewal clause in itself, but rather because of the burden imposed by the circumstance of having to notify the intention to terminate the agreement well in advance (one year) of the expiration of the shareholders’ agreement. This may lead some to think that such tacit renewal clauses may still be considered valid if they provide for the possibility of the shareholder communicating its intention not to renew the agreement until the point of expiration of the agreement, thus preserving the freedom of economic initiative of the shareholders.

iii Fiduciary duties and liabilities

Management and coordination of asset management companies

The Italian Civil Code regulates ‘management and coordination’ activity. This concept, which lacks precise legal definition, relates to the activity or direction exercised by a ‘directing’ company over another company, which is subject to this direction because of specific

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2 Court of Appeal of Brescia, 8 October 2018, Decision No. 1568.
factors. In fact, according to Article 2497 *sexies* of the Italian Civil Code, it is presumed, unless otherwise proven, that the management and coordination of a (subsidiary) company is exercised by the (parent) companies or entities required to consolidate their financial statements or in any case that control them pursuant to Article 2359 of the Italian Civil Code, which, in turn, identifies cases in which control exists. In addition, case law and scholars have identified certain additional characteristics (such as the identity of board members) that help concretise the notion of management and coordination.

The Italian Civil Code provides for the fulfilment of specific requirements for both the directing company and the directed company in a management and coordination situation. In particular, the company subject to management and coordination has to indicate its subjection to the management and coordination activity in its records and correspondence. Both the directing company and the directed company must register themselves with specific registers kept by the Italian Business Register. Pursuant to Article 2497 *ter* of the Italian Civil Code, the decisions of the company subject to management and coordination, when influenced by the directing company, must be analytically motivated and must contain precise indications of the reasons and interests whose evaluation had an impact on the decisions.

Liability of the directing company may arise only in cases of prejudice to the remunerability and value of the shareholding or to the integrity of the company’s assets. Article 2497 of the Italian Civil Code provides for the direct liability of the directing company towards the other shareholders, or the creditors, if the directing company acts in its own interest or in the interest of a third party in violation of the principles of correct corporate and business management.

Traditionally, questions of management and coordination were not considered in relation to asset management companies (SGR), as these manage only funds, which, in turn, hold interest in portfolio companies.

However, in a recent case law decision concerning the management and coordination of an SGR, the Court of Milan held that there was liability towards the other shareholders of the companies owned by the fund managed by the same SGR pursuant to Article 2497. According to the Court, as the SGR has the legal form of a company, it may well exercise management and coordination activity in relation to another company. Therefore, it is irrelevant that the ownership of the controlling interests held by an asset management company is owned by investment funds it manages, since the asset management company has the power to legally act in the name, and on the behalf, of those funds.

As a consequence of this case law, the AIFI issued guidelines to help PE operators to avoid situations where one can see the effective exercise of management and coordination activity for asset management companies. In particular, according to the AIFI:

\[ a \] it is advisable that the boards of directors of the portfolio companies are composed of members different from those sitting on the board of directors of the SGR;

\[ b \] the SGR and the portfolio companies should adopt management protocols aimed at guaranteeing the autonomy of the target companies;

\[ c \] the SGR shall ensure that decisions of the portfolio companies are always taken by the competent bodies of those companies (for example, it is advisable that the decisions of the portfolio companies shall be taken before the decision of the SGR on the same item);

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3 Court of Milan, 9 January 2018, Decision No. 90.
portfolio companies, in their records and documents, including the resolutions of the board of directors, should highlight not the SGR’s decisions on the same topics but (1) the autonomy of the company in taking decisions on those matters; and (2) the interest of the portfolio company in taking those decisions; 

the board of directors of the portfolio companies shall resolve upon, with adequate reasoning, the exclusion of the management and coordination of the SGR; and 

the by-laws of the SGR can provide for the exclusion of management and coordination activity in relation to the portfolio companies.

**Directors’ duty of care and the business judgement rule**

As a direct effect of their appointment, directors of Italian companies are entrusted with the general and exclusive duty to ‘manage the company with care’ and to act in the best interest of the company and in compliance with the obligations set out by the Italian Civil Code and any other applicable laws and the company’s by-laws.

The Italian Civil Code does not specify what degree of care is to be exercised by directors of Srls, whereas, by contrast, this duty is explicitly set out for directors of SpAs. In fact, pursuant to Article 2392 of the Italian Civil Code, directors of a SpA have the general duty to carry out the duties imposed by applicable laws or the company’s by-laws with the care that is required in relation to the nature of their office and their specific responsibilities. According to the majority of Italian commentators, however, the standard of care required of directors of Srls should not diverge substantially from the standard of care required of directors of SpAs.

In particular, this standard of care should be the standard typical of professionals. To assess the degree of care that may be expected from each director in the performance of his or her management activity, the actual duties that the director performs within the company have to be taken into account.

Directors may not be considered liable for any damage suffered by the company as a result of erroneous or inappropriate business choices made during the course of their management, provided that (1) those choices could be considered potentially appropriate, or certainly not damaging for the company, by a person having the standard of care and knowledge expected from the director of a company dealing with the relevant business sector, and (2) the director followed all the procedural steps requested by the applicable laws before taking the decision (the business judgement rule). In particular, should directors act in such a manner that all the above-mentioned duties have been fulfilled, and also in relation to the decision-making process (collecting information, checking information, applying specific know-how and expertise, etc.) and the transparency of the activities, the judge cannot deem them liable for their managing activity, even if the activity has led to decisions that turned out to be inappropriate or inconvenient for the company.

**III YEAR IN REVIEW**

**i Recent deal activity**

Although there is no aggregate data available for 2018 yet, it seems that the year that just ended was characterised by a trend for the consolidation of PE activity in Italy, and this despite the general elections of March 2018, which left the country with basically no government for three months, and the gross domestic product (GDP) data of the final two quarters (GDP fell 0.2 per cent between October and December 2018, following a 0.1 per cent decline in the third quarter, throwing the country into recession).
In the first half-year of 2018, the total deal value had already surpassed the halfway mark of total deal value in 2017, and matched a third of the total volume for 2017.

The Italian market is still characterised by a large number of small- and medium-cap enterprises, mainly family-owned; according to the Italian Association of Family Businesses, there are an estimated 784,000 family-owned firms, which is almost 85 per cent of the firms in the country. The question of succession within such family-owned firms has been among the main drivers for PE deal flows, since PE ownership may circumvent the tensions that can arise from succession issues.

Moreover, Italian SMEs represent a key success factor, by producing high-quality products, mainly in the industrial and consumer goods sectors. More specifically, ‘made in Italy’ companies have earned a well-deserved reputation mainly in fashion, engineering and food. In 2018, there were 123 deals on SMEs registered (the strongest figures recorded since the financial crisis in 2008). According to a survey conducted by Deloitte, almost three-fifths of PE sponsors hold a portfolio of SMEs with an average turnover of €50 million.

ii Financing

In the first half-year of 2018, Italian investments utilised an average percentage of equity of between 41 per cent and 60 per cent, and transactions in which the equity component of the investment was between 61 per cent and 100 per cent increased by 8.2 per cent compared to the results registered in the previous half-year.

Deals were executed with a financial leverage of between two and four times the earnings before interest, tax, depreciation and amortisation (EBITDA). Average spreads ranged between 200 and 300 basis points. More specifically, 58.3 per cent of the transactions were financed with a leverage of between two and four times the EBITDA (down 17.4 points compared to the previous half-year), and transactions financed with a leverage of four to six times the EBITDA grew by 8.3 points compared to the previous half-year.

In 2018, there was a slight increase in senior debt in relation to PE acquisitions; two-thirds of transactions were financed with an average Euribor rate of between 200 and 300 basis points and transactions financed with a Euribor rate of over 300 points grew by 5.6 per cent compared to the second half-year of 2017.

Senior debt is still the most popular financing option, confirming the trend observed in the past half-year. Shareholders’ loan and mezzanine financing are the most popular alternative debt facilities. The percentage of PE sponsors relying on commercial banks for their financing needs is down compared to 2017 (down from 85.7 per cent to 73.5 per cent); syndication financing and other forms of financing are increasing, up by 8.8 per cent and 5.9 per cent, respectively, compared to the previous half-year, while use of investment banking is down by 5.5 percentage points.

iii Insurance

In 2018, warranty and indemnity insurance (W&I) was still broadly used. The use of this insurance allows the parties in a transaction to find an easy and effective compromise with respect to the risk of breach of representations and warranties issued, in the context of a sale and purchase agreement, by the seller to the insurance company. As a matter of fact, on one
hand, W&I is useful for sellers, who in this way can avoid direct liability in cases of breach of representations and warranties and, on the other hand, it is preferable for the purchaser, who can rely on the financial soundness of an insurance company.

IV REGULATORY DEVELOPMENTS

Law No. 124 of 4 August 2017 modified the thresholds for the notification of merger transactions to the Italian Competition Authority (AGCM).

The amended text of Article 16 of Law No. 287 of 10 October 1990 (Law No. 287/1990) now provides that a concentration between companies must be notified in advance to the AGCM not only if the total turnover achieved at national level by all the companies concerned is more than €492 million (as provided in the previous version of Article 16), but also if the total turnover achieved individually at national level by at least two of the companies concerned is more than €30 million.

This amendment introduces into the national merger control system a second significant cumulative threshold, in addition to the existing national turnover limit. In line with the Recommended Practices of the International Competition Network, the rationale for this amendment is a response to the need to establish a significant link with the jurisdiction assigned to evaluate the transaction, with a specific focus on transactions that have a clear local element.

The new system of thresholds, applicable for transactions to be executed from 29 August 2017, brings the Italian merger control system in line with European legislation (EU Regulation No. 139/2004). Both the EU and the Italian legislation now require that at least two of the companies concerned each exceed a minimum ‘domestic’ turnover threshold, in addition to the additional requirement that all companies involved in the transaction exceed a certain turnover threshold aggregate.

By reducing the lower of the thresholds from €50 million to €30 million, and removing the reference to the company being acquired, this reform will increase the number of concentrations subject to prior notification in Italy and reduce the risk that certain problematic operations escape the control of the Italian Competition Authority. In any case, while the new set of thresholds might have a moderate impact on the notifications of acquisitions of a company by another single company, it could have a considerable effect in the case of ‘joint ventures’, in which at least two companies combine part of their activities or jointly acquire an existing company. Moreover, according to the new Article 16 of Law No. 287/1990, it is also mandatory to notify the transaction where only the turnover of the company resulting from the merger exceeds the turnover threshold. In this respect, it will be interesting to see how this criterion will actually be applied by the Italian Competition Authority to avoid transactions having to be notified when they have no effect on a national market or part of it.

V OUTLOOK

It is difficult to predict how 2019 will turn out for PE sponsors and operators in general. As far as Italy is concerned, as discussed above, the latest GDP data is signalling that a recession has started and this might discourage investors or result in divestments by PE firms of their current participations in portfolio companies. The reforms introduced by the newly established government do not seem able to overturn the negative expectations regarding the macroeconomic framework in general. Nonetheless, the Italian market appears to be very
competitive in terms of pricing, and this is because many potential target companies are still 'mom-and-pop stores', which have no real access to financing and face family governance issues, in turn representing ideal ground for a third-party investor to come in and create value. We would not be surprised, therefore, if 2019 ends up confirming the consolidating trend of 2018.
I OVERVIEW

i Deal activity

The Japanese private equity market continues to be quite active, taking advantage of the stability of the economy since 2013. Also, due to monetary easing and the negative interest rate policy adopted by the Bank of Japan, it has become easier for private equity firms to raise acquisition financing from Japanese banks. According to the RECOF M&A database, 79 acquisition transactions by investment firms (most of which are private equity funds) were announced during 2019, which was less than the 89 deals in 2007 (prior to the Lehman crisis) but a steady increase from the 69 deals in 2017. Among them, five deals were contemplated as public-to-private transactions.

There has been a growing number of small and medium-sized transactions involving succession of family owned companies. Additionally, as a result of the continuous review of business portfolios as recommended under the amended Japan’s Corporate Governance Code, an increasing number of listed companies have been implementing divestitures of subsidiaries and non-core businesses.

According to the RECOF M&A database, there have been around 50 exit transactions per annum by investment firms through trade sales or secondary buyouts in recent years. This trend has continued, with 48 deals announced during 2019.

There are several types of private equity funds that are active in Japan. Many of the mega-deals are conducted by global funds such as KKR, Bain Capital, Carlyle and Blackstone. There are also independent domestic funds, such as Unison Capital, Advantage Partners and Integral, as well as funds managed by financial institutions such as banks and securities companies.

Further, government-related funds have recently been playing an increasingly important role in the private equity market. A remarkable example is the Japan Investment Corporation (JIC), which is a public–private fund sponsored by both the Japanese government (injecting ¥286 billion) and 25 private corporations (¥13.5 billion in total). Although JIC has been inactive following the resignation of all directors from the private sector due to a dispute with the government over their compensation, it is reported that it will restart investment activities under new management established in December 2019.

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Operation of the market

Management incentive arrangements

Typical management incentive arrangements adopted in private equity deals in Japan include performance-based annual bonuses and stock options. In addition, top management can hold minority shares in the company. Private equity funds commonly enter into agreements (e.g., executive services agreement) with management to set out predetermined performance targets for annual bonuses to incentivise the management. Stock options are occasionally subject to performance vesting features. Stock options often become exercisable upon exit of the private equity fund.

Sales process

The most common forms of exit by private equity funds are trade sales, secondary buyouts and initial public offerings (IPOs). Particularly, a trade sale of shares to a strategic buyer that conducts a business similar to that of the target company is the most common exit form, with its simple and straightforward nature enabling the private equity fund to obtain an immediate return on the entire investment (although there may remain indemnity obligations or a balance of payment held in escrow). To induce the most favourable terms for the sale, private equity funds as sellers tend to conduct an auction process before starting negotiations with the selected buyer on an exclusive basis.

There has recently been an increase in secondary buyouts. The secondary buyout is an attractive option where, for example, the initial buyout fund’s investment period is close to expiry but the IPO of the portfolio company is expected to run for longer.

Also, since the revival of the Japanese IPO market, a growing number of private equity funds have been trying to exit through IPOs, which was once uncommon in the Japanese private equity market. While the possibility of an IPO largely depends on the market environment, and the preparation for an IPO usually requires much time, resources and cost, an IPO could be an attractive option in that it could realise greater value without imposing heavy post-closing liabilities on the seller.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Buyouts of private companies

In the case of buyouts of private companies, the most common legal framework is a simple sale and purchase of shares in the target company. A stock purchase agreement entered into between the seller and the buyer is the principal document providing the terms and conditions of the transaction.

Buyouts of listed companies

Buyouts of listed companies (i.e., public-to-private transactions) are typically conducted through a two-step acquisition involving a first-step tender offer and a back-end squeeze-out of the remaining minority shareholders.

An acquisition of shares in the first-step transaction needs to be conducted pursuant to the tender offer regulations under the Financial Instruments and Exchange Act (FIEA), which require a tender offer for a transfer of listed shares resulting in the acquirer holding more than one-third of the voting rights of the listed company. The principal documents
for buyouts of public companies are the tender offer documents such as the tender offer registration statement filed by the offeror (buyer) and the position statement filed by the target company. Terms and conditions of the tender offer are provided in the tender offer registration statement to be prepared in accordance with the FIEA and relevant regulations. Also, in cases where the target company has a major shareholder, a tender offer agreement may be entered into between the offeror and the major shareholder, which provides the offeror's obligation to commence the tender offer and the major shareholder's obligation to tender in the tender offer. The offeror and the target company are not prohibited from agreeing upon deal protection measures such as a no-shop clause and breakup fees, but tend to avoid doing so to ensure fairness of the transaction process.

For the back-end squeeze-out, two practical alternatives have been commonly used: (1) a squeeze-out right that is available to a special controlling shareholder, and (2) a fractional share squeeze-out through, among other things, a stock consolidation. The squeeze-out right, which was introduced with the 2016 amendment of the Companies Act, enables a shareholder holding (directly or through one or more wholly owned subsidiaries) at least 90 per cent of the total voting rights (special controlling shareholder) to force a cash acquisition of the remaining shares held by the minority shareholders. The effect of the squeeze-out right is simple and straightforward; the relevant shares are transferred directly from the minority shareholders to the special controlling shareholder. This alternative only requires a resolution of the board of directors of the target company instead of a shareholder resolution (which typically takes a couple of months), and, therefore, significantly expedites the squeeze-out procedure in comparison with the other alternatives. In practical terms, it is possible to complete the back-end squeeze-out as early as one month after completion of the first-step tender offer. Due to the simple and expedited procedure, since its introduction under the amended Companies Act, the squeeze-out right has been most commonly used for back-end squeeze-outs where the acquirer satisfies the 90 per cent voting rights requirement. Another alternative available for the back-end squeeze-out is a fractional share squeeze-out, which is typically conducted through a share consolidation. In this type of squeeze-out, the target company, pursuant to a shareholder resolution, consolidates its shares by a ratio that would result in minority shareholders holding only fractional shares. In accordance with a procedure provided under the Companies Act, these fractional shares are not actually issued but sold to the acquirer upon court approval, with the cash proceeds distributed proportionately to the minority shareholders. A fractional share squeeze-out does not require the acquiror to hold 90 per cent of the voting rights of the target. Therefore, if the acquirer fails to reach the 90 per cent threshold on completion of the first-step tender offer, making the squeeze-out right unavailable, a fractional share squeeze-out would still be available as long as it is approved by a shareholder resolution with a supermajority vote (two-thirds of the votes cast).

In contrast, cash mergers have not been commonly used for back-end squeeze-outs because, unlike the common alternatives above, a cash merger was treated as a taxable transaction at the level of the target company. However, such difference in tax treatment was eliminated after the amendment to the Corporation Tax Act in 2017. Given that cash mergers are available through a shareholder resolution of the target company with a supermajority vote even if the 90 per cent voting rights requirement is not satisfied, they may be used more commonly in the future.
Antitrust filing requirements
Under the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (the Antimonopoly Act), a pre-transaction filing is required for an acquisition of more than 20 or 50 per cent of the voting rights of the target company if the aggregate amount of the domestic sales of the buyer group exceeds ¥20 billion or the aggregate amount of the domestic sales of the target company group exceeds ¥5 billion, respectively. In the case of an acquisition by a private equity fund, the domestic sales of the fund’s portfolio companies may be included in the sales of the buyer group, depending on the fund structure. If the pre-transaction filing is necessary, a 30-day waiting period (which may be shortened if the transaction does not raise substantive antitrust issues) is applicable and could affect the closing schedule.

Foreign investment filing requirements
The Foreign Exchange and Foreign Trade Act (FEFTA) obliges a foreign investor contemplating a certain foreign direct investment (FDI) to make a pre-transaction notification if the FDI targets certain restricted businesses. FDIs subject to the pre-transaction notification requirements are reviewed by the Ministry of Finance and other relevant ministries and subject to a statutory waiting period of 30 days. The waiting period can be extended to up to five months, but would usually be shortened to two weeks or less as long as the FDI does not raise any regulatory concern.

Recently, there have been a series of amendments to the pre-transaction notification requirements under the FEFTA. Most importantly, an amendment that added 20 types of businesses (newly added businesses) to the list of restricted businesses became effective on 1 August 2019, and pre-transaction notifications are required for FDIs targeting newly added businesses consummated on or after 31 August 2019. The newly added businesses are divided into the following categories:

a. manufacturing of information processing equipment and parts;
b. software related to information processing; and
c. information and communications services.

Among others, the software category is very widely defined, and any business involving development of software that is not game software could be deemed to fall under this category. The authorities also tend to interpret the scope of internet use support services, which fall under the information and communications services category, widely, and any business providing internet services (including services that are not typically seen as support services) could be deemed to fall under this category. As such, the newly added businesses category may apply to a wide range of businesses, including start-up and technology companies. Additionally, it has been clarified that a general partnership, limited partnership for investment under the Limited Partnership Act for Investment of Japan, and other similar partnerships under foreign laws fall within the foreign investor category if 50 per cent or more of the contributions are made by non-residents, or a majority of the general partners are non-residents. Therefore, private equity funds satisfying these criteria will be required to make pre-transaction notifications in a much broader range of transactions than before.
ii Fiduciary duties and liabilities

Fiduciary duties

Under Japanese law, it is commonly understood that a controlling shareholder does not owe any fiduciary duty to the minority shareholders. On the other hand, company directors owe a fiduciary duty to the company, which could include a duty to take account of the shareholders’ common interests. Particularly, as the Tokyo High Court ruled on 17 April 2013, in the case of management buyouts by a two-step acquisition as described in Section II.i, directors of the target company owe the duty to ensure a fair transfer of corporate value among the shareholders and the duty to disclose adequate information.

In addition, a highly remarkable ruling by the Supreme Court on 1 July 2016, involving a public-to-private transaction conducted by certain major shareholders of the target company through a two-step acquisition, held that the squeeze-out price is generally considered fair if it equals the price offered in the first-step tender offer and is determined through a fair process. While the Supreme Court ruling in the *Jupiter Telecom* decision directly relates to the fairness of the squeeze-out price to be examined in an appraisal procedure, it also has a significant impact on the discussion regarding the duties of directors of the target company under similar circumstances (i.e., conflict-of-interest transactions).

Contractual duties and liabilities

Upon its entry investment, a private equity fund as buyer may owe certain (though limited) post-closing duties, including continued employment of the target company employees, under the stock purchase agreement (in the case of buyouts of private companies) or the tender offer agreement (in the case of buyouts of listed companies).

In contrast, upon exit, a private equity fund as seller would owe broader contractual liabilities under these agreements, including liabilities for indemnification in relation to any breach of representations and warranties or covenants. Depending on the bargaining power of the seller under the specific circumstances, the seller typically strives to limit the scope of its representations, warranties and covenants and to otherwise add contractual mechanisms to limit its post-closing liabilities, such as a limitation on the amount of indemnification (e.g., cap, *de minimis*, deductible or tipping basket) and a limitation on the period for indemnification (e.g., survival period of representations and warranties).

III YEAR IN REVIEW

i Recent deal activity

On 28 June 2019, the Ministry of Economy, Trade and Industry (METI) formulated the Practical Guidelines for Group Governance Systems, which, among other things, pointed out the conflict-of-interest issues between the general shareholders of a listed subsidiary and its parent company. To address these issues, an increasing number of Japanese companies that have listed subsidiaries have been considering an acquisition of the remaining shares in the listed subsidiary (i.e., public-to-private transaction) or a sale of the listed subsidiary. In the latter case, private equity funds could be good candidates for buyers.

Also, the Fair M&A Guidelines formulated by METI on 28 June 2019 emphasised the need to take appropriate measures to ensure the fair process for conflict-of-interest transactions.
such as management buyouts and acquisitions of listed companies by controlling shareholders (including parent companies). These measures include market checks and the establishment of a special committee and majority-of-the-minority conditions. While the scope of direct application of the Fair M&A Guidelines is limited to the conflict-of-interest transactions described above, it is generally understood that reference to the Fair M&A Guidelines could contribute to ensuring the fairness of other types of M&A transactions, including the sale of listed subsidiaries by parent companies. In light of the Fair M&A Guidelines, there have been an increasing number of transactions involving private equity funds as buyers where special committees are established or active market checks are conducted through an auction process or an individual solicitation to multiple-buyer candidates.

The most significant deals in recent years include the acquisition of KIOXIA Holdings Corporation (formerly Toshiba Memory Corporation) by Bain Capital and other investors in 2017, and the acquisition of Marelli Corporation (formerly Calsonic Kansei Corporation) by KKR in 2017.

ii Financing

Typical leveraged buyouts by private equity funds are funded by the composition of debt and equity (typically in the form of common stock). The debt-to-equity ratio generally ranges from 2:1 to 1:1.

The debt financing package typically consists of a senior term loan facility and revolving facility for working capital purposes. Typically, one or more arranger banks underwrite these facilities upon the acquisition, and then syndicate these facilities within a general syndication period (which is usually six months to one year after the signing or first use). Some transactions also use mezzanine financing, which is usually structured as subordinated loans, subordinated bonds, subordinated convertible bonds or preferred shares. Equity kickers, typically in the form of stock options, are sometimes granted to mezzanine finance providers as an incentive. Interest payments under mezzanine financings often include, together with cash payment interest, payment-in-kind interest, which is usually accrued on a compounded basis that will become due on the maturity date, after full repayment of senior debt. High-yield debt is not commonly used.

In acquisition financing, the lenders usually request a long list of (1) conditions precedent for the drawdown, (2) representations and warranties that are repeated with each use, (3) covenants, including financial covenants and capex restrictions, and (4) events of default. Among other things, it is notable that the lenders usually require inclusion of an absence of material adverse change as a condition precedent for the drawdown. This means that a private equity fund as buyer usually needs to include the equivalent condition precedent for the completion of the acquisition under the stock purchase agreement (or, in the case of a tender offer, for the commencement of the tender offer).

iii Key terms of recent control transactions

Antitrust clearance

We have recently seen an increasing number of transactions in which antitrust clearance in one or more jurisdictions is required prior to the closing. Particularly, global-based private equity funds often need to obtain clearance from the antitrust authorities in multiple jurisdictions. In some cases, it takes a long time to close the transaction due to such antitrust requirements. In this regard, it is notable that, in the case of a tender offer, the competent governmental authority (Kanto Financial Bureau) usually requires the necessary antitrust
clearance to be obtained prior to the commencement (as opposed to the settlement) of the tender offer. This could further delay the commencement of the tender offer and cause the whole deal process to take an even longer time.

In transactions requiring antitrust clearance, obtaining such clearance by the buyer is usually included as a condition precedent in the stock purchase agreement or the tender offer agreement. On the other hand, the seller would request contractual arrangements to ensure deal certainty. In this context, we have recently seen some transactions that have included a reverse breakup fee payable by the buyer if it fails to obtain necessary antitrust clearance. Additionally, especially in a competitive auction process, private equity funds sometimes accept a ‘hell-or-high-water clause’ to enhance their position as compared to strategic bidders from an antitrust perspective.

**Conditionality**

In buyouts of private companies, the stock purchase agreement typically provides customary conditions precedent, such as absence of breach of representations, warranties and covenants; necessary approvals of relevant authorities (including the antitrust clearance discussed above); and third-party consent. In addition, a private equity fund typically requests the closing to be conditioned on the absence of any material adverse change. Depending on the buyer’s negotiating leverage, a finance-out condition is also provided in some cases.

For buyouts of listed companies, the terms and conditions of the tender offer need to be in accordance with the FIEA. Therefore, a narrower scope of contractual scope is allowed, and the contractual buyer protections available to private equity funds tend to be much more limited than those available for buyouts of private companies. In particular, due to the strict restrictions on withdrawal of a tender offer under the FIEA, it is difficult to effectively provide conditions precedent as broad as those typically provided in a stock purchase agreement for buyouts of private companies.

**Representation and warranty insurance**

In Japan, the use of representation and warranty insurance has not been common, partly due to the time involved and the cost of purchasing the insurance. While domestic insurance companies have recently begun to provide representation and warranty insurance, foreign insurance companies are still dominant in this area. Therefore, it is usually necessary to prepare the due diligence report in English as well as provide an English translation of the acquisition documentation. Communication in English is also required in the underwriting call.

However, as the advantage of representation and warranty insurance is beginning to be broadly recognised among practitioners, we may see more transactions in which representation and warranty insurance is used. In particular, it is generally recognised that representation and warranty insurance could be beneficial where a private equity fund as seller desires to limit post-closing liabilities or where a private equity fund as a buyer candidate in the auction process desires to make its proposal more attractive to the seller.

**Exits**

A total of 48 exit transactions by private equity funds through a trade sale or secondary buyout were announced during 2019.
IV REGULATORY DEVELOPMENTS

A control investment by a private equity fund may be subject to the pre-transaction filing or notification requirements under the Antimonopoly Act and the FEFTA. In particular, after the recent amendment to the FEFTA, a broader range of acquisitions by private equity funds are likely to be subject to the pre-transaction notification requirements (see Section II.i).

V OUTLOOK

Given the currently stable economic situation in Japan, continued growth of the Japanese private equity market can be expected going forward.

One of the potential changes we may see in the M&A market relates to hostile deals. Until recently, hostile takeovers, including competing tender offers after the announcement of originally friendly tender offers, had been uncommon in Japan, and there had been few precedents of successful hostile takeovers of Japanese listed companies. However, we have recently seen more cases of successful hostile takeovers (e.g., Itochu Corporation’s partial tender offer for Descente Ltd) and of originally friendly tender offers failing due to a competing tender offer with a higher price (e.g., the failure of Bain Capital’s tender offer for a management buyout of Kosaido Co, Ltd). As the negative perception against hostile takeovers is decreasing, we may see more cases of successful hostile takeovers in the near future.
Chapter 10

LUXEMBOURG

Frank Mausen, Patrick Mischo, Peter Myners and Jean-Christian Six

I OVERVIEW

i Deal activity

During the course of the past decade, Luxembourg has become one of the most important hubs for private equity capital raising and transaction activity in the world. Every year Luxembourg investment platforms raise huge amounts of capital and deploy it across hundreds of private equity transactions within the European Union and beyond, and this year was no exception.

Luxembourg investment platforms come in different shapes and sizes, as do the managers that manage them, ranging from mega funds with multibillion-euro flagship funds established in Luxembourg managed by Luxembourg AIFMs with many hundreds of Luxembourg holding companies, to more bespoke, stand-alone structures. Private equity managers with a substantial presence in Luxembourg include EQT, CVC, Apollo, Oaktree, Blackstone and Lone Star.

With so many private equity investments being held by Luxembourg holding companies, it is no surprise that a large and increasing number of M&A transactions involve target companies or target groups that are established in Luxembourg. It is fair to say that the majority of M&A activity involving Luxembourg companies concerns holding companies (i.e., Luxembourg companies that hold assets outside Luxembourg, rather than operational companies). However, private equity funds or their portfolio companies have acquired and continue to participate in sales processes involving Luxembourg-based businesses. A particularly hot sector over the past year or so has been the Luxembourg funds sector – fund managers, fund administrators, fund exchanges and the asset management arms of financial institutions – as investors look to gain exposure to the buoyant funds industry (e.g., Estera, a Bridgepoint portfolio company, has acquired Headstart and Allegro).

ii Operation of the market

A Luxembourg private equity structure will often involve co-investment, joint venture arrangements or management incentivisation. In these structures, rather than being wholly owned by the fund, equity or debt instruments are issued by the Luxembourg company to various stakeholders, and for the sponsor it will be essential to maintain control. It is possible under Luxembourg law for the sponsor to maintain that control, while at the same time accommodating the commercial interests of other stakeholders, provided that the appropriate
types of company and instruments are used and the rights and obligations of each party are clearly set out in applicable contractual arrangements as well as the constitutional documents of the Luxembourg company.

A key structuring discussion will be in relation to the form of instruments to be issued. Luxembourg law provides for a wide range of possibilities: ordinary share capital, preferred equity, redeemable shares, tracking shares, founder shares, preferred equity certificates, fixed interest loans and bonds, variable interest loans and bonds, or (as is typically the case) some combination of these. A common reason for having a mix of instruments, rather than financing purely through equity, is to avoid a ‘cash trap’ situation in which there are insufficient distributable amounts to enable a dividend to be declared or shares to be redeemed.

The sharing of the proceeds of an investment – whether during the life of the investment or at exit – can be disproportionate to the amount of share capital or (in the case of debt) principal held by the relevant stakeholders. Management or other stakeholders can hold a de minimis stake in percentage terms, and, therefore (in the case of equity and debt instruments such as bonds that are subject to voting arrangements), a small proportion of voting power, while participating in substantial upside via a commercially agreed waterfall that is linked to internal rate of return performance. There are some Luxembourg law constraints (e.g., it is not possible to entirely exclude the risk of losses or the possibility of obtaining a return – the clause léonine rule), but in general parties have contractual freedom to set out their agreed commercial terms.

Private equity sponsors who structure management incentivisation packages (MIPs) using Luxembourg companies will want to ensure that management cannot prevent them from exercising control and, for example, exiting when the time is right. Management would typically hold a small number of shares and undertake either not to vote or to vote as the sponsor directs. These voting waivers and undertakings must be carefully drafted, and they are often combined with default clauses, powers of attorney, call options or share pledges. Following the recent reform of the Luxembourg companies act, it is possible for a board to suspend the voting rights of a shareholder who breaches the company’s constitution. It is also possible in certain types of Luxembourg companies to issue non-voting shares. Where this is not possible, founder shares are a common alternative. These do not form part of the share capital but may be voting or non-voting and may have such economic rights as the articles provide.

Ensuring that management exit when required to do so can be achieved in a number of ways: (1) drag-along provisions backed by call options or share pledges in favour of the sponsor or fund, or (2) by ‘corralling’ management into a separate MIP vehicle, such as a partnership limited by shares (SCA) or a limited partnership (SCS), which then invests alongside the main fund. Such an MIP vehicle would typically be managed by the sponsor, so that any consents that are required in connection with an exit are certain to be given, with management holding limited partnership interests and, typically, having the benefit of certain limited veto rights designed to protect their economic interests. This means that if there are disputes with or among management members as to their respective entitlements, these disputes are isolated within the MIP vehicle and litigation will not threaten to derail the sales process.
II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The Luxembourg ‘toolbox’ has expanded over the years and is now extensive and able to accommodate most structuring requirements. A typical private equity investment structure might include one or more SCS or special limited partnership (SCSp) funds to raise capital from investors at the top of the structure, and multiple master, intermediate or asset level holding companies (often Sàrls) below the fund. These holding companies are typically used to accommodate co-investors or joint venture partners, obtain senior, mezzanine or other forms of financing, issue bonds, incentivise management or simply block potential liability.

The Sàrl remains the most frequently used type of Luxembourg entity, but in terms of relative growth the SCS and SCSp have become increasingly popular. The SCA is also another frequently used type of entity. Each of these vehicles has specific features from a legal and tax perspective, and it is important to consider these features in light of the commercial drivers and dynamics of the particular structure.

Increasingly, transaction documents are governed by Luxembourg, as opposed to English or New York, law. Private equity participants are increasingly comfortable with the limited partnership agreements of their flagship funds, investment or shareholders’ agreements of their co-investments, joint ventures or MIPs and share purchase agreements governing their exits or acquisitions to be governed by Luxembourg law and submitted to Luxembourg courts or arbitration.

The general principle under Luxembourg law is one of contractual freedom. However, there are some constraints that parties must bear in mind: basic contract law requirements such as ensuring that the rights and obligations of the parties are determinable, limiting the agreements and certain specific clauses in time, ensuring that transfer restrictions and voting undertakings are enforceable, the good-faith principle and avoiding penalties or conditions that are under the subjective control of the party seeking to rely on them.

Regardless of the governing law, Luxembourg corporate law requirements have to be taken into account, and can often have a significant effect. Corporate law issues that regularly arise on private equity structures include the rules and procedure around mergers and demergers, pre-emption rights, authorised share capital, the requirement for consent to transfer to third parties, the inability to have weighted voting rights at board level, the equal treatment of shareholders, the rules against abuse of assets, the requirement to obtain majority thresholds within each share class where the rights of holders of a particular class are adversely affected, the absence of a concept of alternate directors, conflicts of interest and financial assistance. Most market participants will be familiar with these concepts.

Another issue that frequently arises is the ‘substance’ of a Luxembourg entity. This is relevant from a tax perspective, but also from a corporate perspective. Luxembourg adopts a ‘real seat’ rather than ‘incorporation’ theory, meaning that a company that is incorporated as a Luxembourg company can migrate to a different country by virtue of the shifting of its place of effective management. Care must be taken to maintain effective management in Luxembourg – Luxembourg-resident board members and physical board meetings, supported by robust convening processes and minute-taking.

Checking the substance of a target Luxembourg company is one of a number of due diligence issues that often arise on acquisitions of Luxembourg companies. Others include: (1) title and compliance with laws – ensuring that the company’s incorporation and subsequent corporate actions have taken place in accordance with the law, and that the shares and any other instruments have been validly issued and are held by the seller free from
encumbrances; (2) ensuring that the relevant consents to transfer are identified and obtained; (3) ensuring that the company is in good standing and is up-to-date with its filings, including the approval and filing of its annual accounts; and (4) solvency. In relation to this last item, Luxembourg does not have a balance sheet solvency test, but rather a Luxembourg company is insolvent if it is unable to pay its debts when they fall due and it has lost its creditworthiness.

ii Fiduciary duties and liabilities

The governance of Luxembourg companies has become increasingly sophisticated over the years. The use of two-tier board structures, committees, observers, the delegation of specific powers to specific individuals or groups of individuals, the granting of daily management powers and the use of reserved matters are all common in private equity structures. Most Luxembourg companies will be subject to a conflict-of-interest regime and board composition, quorum and voting thresholds must be structured with attention to the definition of a conflict of interest.

Board members of Luxembourg companies are subject to a range of duties and, as a general rule, owe those duties to the companies to which they have been appointed and not to the shareholders who appointed them. In certain circumstances, board members may take into account the interests of other group companies, but the ‘corporate interest’ in doing so has to be assessed on a case-by-case basis, including the extent to which the relevant action is expressly set out in the corporate object of the company, the financial means of the company, the materiality of the relevant matter relative to those means, the extent of any remuneration to be obtained by the company and other relevant factors. Director and officer insurance and indemnity is very common, as is the granting of ‘discharge’ at the annual general meeting of shareholders and at exit.

We have yet to see frequent use of ‘fairness opinions’ in private equity deals in the same way as they are used in other jurisdictions. Luxembourg law requires valuations to be prepared in certain circumstances, for example upon a contribution in kind of an asset to certain types of Luxembourg company. But there is no general trend towards boards obtaining fairness opinions to support their decisions on exits.

Shareholders of Luxembourg companies do not owe fiduciary duties to the companies in which they participate. However, parties to Luxembourg law-governed contracts do owe a general duty of good faith, and there are rules against abuse of corporate assets and similar minority protections.

It is often crucial to ensure that liability with respect to a particular investment, external financing or joint venture arrangement is blocked and managed at an appropriate level, away from the flagship fund or master holding company. Piercing the corporate veil (i.e., a shareholder becoming responsible for the liabilities of a limited liability company) is rare under Luxembourg law, and parties can have confidence that in the absence of a dissolution, merger or similar form of corporate transaction whereby one entity absorbs the assets and liabilities of another, and as long as the relevant company has normal governance and is managed in a manner that is independent of its shareholders, the liability blocker will be effective. The Luxembourg securitisation vehicle (i.e., a company that is subject to the Luxembourg securitisation act of 22 March 2004, as amended) goes one step further and allows for statutory segregation or ring-fencing of compartments: investors in and creditors of one compartment may not sue on the assets of another compartment. The Securitisation Act 2004 also expressly recognises the validity of limited recourse, subordination, non-seizure and non-petition provisions.
**III YEAR IN REVIEW**

**i Recent deal activity**

The main development in recent years in Luxembourg has been the new Companies Act in 2016 and its subsequent ‘bedding in’, as market participants become familiar with its practical impact. One area that has been the subject of significant attention in contractual documentation and articles of association is the ‘Section 189 issue’ (now Section 710). Section 710, as it is now, applies to Sàrls and, as well as requiring transfers to third parties to be approved by shareholders representing three-quarters of the share capital, gives shareholders a right to exit by offering their shares to other shareholders or to the company at a price that is set out in the articles or, if no price is stated, at a price to be determined by a court. This may be inconsistent with the commercial intent of the parties and, if that is the case, a number of possible solutions can be deployed. Some market participants simply retain the Section 710 mechanism but state a low price, thus disincentivising its use.

An increasingly important structuring driver is speed. The ability to move quickly is often key to winning sale processes, and to be able to do so while preserving good governance, strong information flows and processes have to be put in place. Relevant corporate bodies must have the information and time that they require to make an informed decision on a particular matter, and once that matter has been approved it has to be implemented quickly: cash often has to flow down a structure in a matter of hours. Often that cash is injected into a Luxembourg company as a combination of debt and equity. On the equity side, the issuance of share capital in most types of companies (excluding certain funds) requires an extraordinary general meeting before a Luxembourg notary, additional notary know-your-customer formalities and the blocking of the subscription monies pending the issuance of shares. Often this has to take place at multiple levels. In response, certain market participants make use of the ‘capital surplus’ or ‘equity reserve account’ procedure, which is intended to constitute equity without the issuance of shares and avoid the need for a notary. This is not a mechanism that is set out in the law and it should only be used with appropriate and specific accounting, tax and legal advice. Certain market participants have moved or are moving away from this mechanism and instead use a form of convertible ‘shareholder advance’ to solve the logistical constraints involved in issuing share capital. The shareholder advance is converted or capitalised into the relevant mix of share capital (with or without issuance premium) and debt as soon as possible following the actual flow of funds.

There have been a number of recent developments in Luxembourg tax law, in particular the implementation into Luxembourg domestic law of the EU Anti-Tax Avoidance Directive (ATAD 1),\(^2\) which may have an impact on Luxembourg companies that are used in private equity transactions.

The law implementing ATAD 1 into Luxembourg tax law (the ATAD 1 Law) was passed by the Luxembourg parliament on 18 December 2018. Most of the provisions of the ATAD 1 Law have applied since 1 January 2019 to accounting years starting on or after this date. The Luxembourg legislature has endeavoured to retain the most flexible options granted by ATAD 1 but without leaving the framework designed by the European Union.

The ATAD 1 Law contains, inter alia, a general interest limitation rule, which provides that taxpayers are only able to deduct ‘exceeding borrowing costs’ incurred up to 30 per cent

\(^2\) Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
of the taxpayer’s earnings before interest, taxes, depreciation and amortisation. Exceeding borrowing costs are deductible borrowing costs that exceed taxable interest revenues and other economically equivalent taxable revenues the taxpayer receives. Exceeding borrowing costs that cannot be deducted in a given period by application of this new interest limitation rule, as well as unused interest capacity, may nevertheless be carried forward.

In accordance with ATAD 1, the Law grants taxpayers a de minimis threshold of €3 million to deduct exceeding borrowing costs. The Law has further introduced a grandfathering rule for loans granted before 17 June 2016, a carve-out for public long-term infrastructure projects, a carve-out for financial undertakings, including securitisation undertakings, as defined under Regulation (EU) 2017/2402,3 and a carve-out for standalone entities, which are entities that are not part of a consolidating group for financial accounting purposes and have no associated enterprise or permanent establishment situated in a country other than Luxembourg.

This new interest limitation rule may, under certain circumstances, result in additional taxation at the level of Luxembourg companies involved in domestic leveraged buyout transactions, as interest on internal and external debt will no longer be fully deductible. The Luxembourg government’s proposal to retroactively amend the new interest limitation rule to allow the Luxembourg taxpayers to opt for the application of the new rule at the level of tax unity should thus be welcomed.

Back-to-back arrangements involving financing companies are not affected by the new interest limitation rule, in the absence of any exceeding borrowing costs.

The ATAD 1 Law also implements into Luxembourg domestic law a new general anti-abuse rule (GAAR) and a controlled foreign company rule (CFC). The new definition of abuse of law under the GAAR should facilitate the tax authorities’ burden of proof given that the tax authorities will only have to prove that one of the main purposes of an arrangement is to obtain a tax advantage. The CFC rule has the effect of including certain non-distributed income of low taxed subsidiaries and branches of a Luxembourg company in the company’s Luxembourg corporate income tax base. The impact of both the GAAR and CFC for Luxembourg companies involved in private equity investments will have to be assessed on a case-by-case basis, as these rules rely on factual considerations rather than on an objective test. Indeed, the CFC provides for a substance carve-out for controlled foreign companies carrying out a substantive economic activity. With respect to the GAAR, the taxpayer should also be able to avoid the application of the rule if it can demonstrate, in accordance with existing Luxembourg and EU case law, that the arrangement is genuine with regard to all the relevant facts and circumstances, meaning that the arrangement has been put in place for valid economic reasons outweighing the tax advantages of the arrangement.

Finally, the ATAD 1 Law has also implemented into Luxembourg domestic law an anti-hybrid rule, as provided under ATAD 1. This anti-hybrid rule targeted hybrid mismatches (i.e., different characterisations of a financial instrument or an entity), giving rise to a situation of double deduction or deduction without inclusion in the context of a structured arrangement or between associated enterprises. The anti-hybrid rule merely covered hybrid mismatches in a purely EU context. The anti-hybrid rule under ATAD 1 was subsequently

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amended in 2017 by the second EU Anti-Tax Avoidance Directive (ATAD 2). ATAD 2 has, in particular, clarified the material scope of the anti-hybrid rules and has extended these rules to hybrid mismatches involving third countries.

The law implementing ATAD 2 into Luxembourg tax law (the ATAD 2 Law) was passed by the Luxembourg parliament on 20 December 2019. Most of the provisions of the ATAD 2 Law have applied since 1 January 2020 to accounting years starting on or after this date, except for the rule on reverse hybrid mismatches, which will apply from 1 January 2022.

The anti-hybrid provisions introduced by the ATAD 2 Law may, under certain circumstances, result in additional taxation at the level of the Luxembourg companies that are used in private equity transactions, in particular for those companies carrying out intragroup financing activities. The application of these provisions in the context of investment funds needs to be monitored closely, as there are a number of uncertainties in the ATAD 2 Law and lack of guidance as regards the interpretation of a number of concepts. The potential impact of these provisions would, in any case, need to be assessed on a case-by-case basis.

ii Financing

Whether they are acquiring assets within Luxembourg or beyond, private equity funds typically obtain external finance. Luxembourg benefits from a strong but flexible legal framework when it comes to the options for financing private equity transactions. Sponsors can choose from a wide range of financing methods, which vary from equity or equity-linked instruments to hybrid instruments and pure debt instruments.

Standard bank financing remains the preferred method of financing and normally accounts for the major part of the funding of a private equity transaction. Private equity transactions up to €200 million are commonly financed solely by one major international bank. On larger deals, borrowers often approach syndicates to raise the required funds. Although these bank loans normally do not originate in Luxembourg, the borrowers, guarantors and obligors are often Luxembourg-based companies. In recent years, Luxembourg-based alternatives such as debt funds provide an increasingly attractive complement to the standard bank loans, as those funds can often offer better terms.

Issuances of high-yield debt securities are becoming increasingly popular and they offer great flexibility. This method of financing attracts less public attention as compared to standard loans but opens the door to the international capital markets and, therefore, also to additional capital. The Luxembourg Stock Exchange (LuxSE) is very competent and most high-yield debt securities are either listed on the regulated market or on the Euro MTF of the LuxSE. Recently, the LuxSE added a third listing venue – the Securities Official List (SOL). An admission to SOL is a pure listing without admission to trading. Listed securities will appear on the official list of the LuxSE. Admission to SOL is subject to compliance with a specific rule book, which provides for lower requirements in terms of disclosure and documentation compared to the documentation for listings on the regulated market of the Euro MTF market of the LuxSE. In addition, neither the Transparency Act nor the Market Abuse Regulation apply to SOL. It is, therefore, expected that this new listing venue will become popular for listings of high-yield debt securities.

Transactions that require a large amount of external funding are commonly financed by a combination of loans and bonds.

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The Luxembourg Collateral Act (of 5 August 2005, as amended) provides a very robust and efficient framework to allow lenders and other creditors to protect their interests. The most frequent way of securing indebtedness in Luxembourg is by pledging the assets of the borrower and the assets of other members of the borrower’s group. This can take the form of a pledge agreement over shares, receivables or bank accounts. The robustness of the Collateral Act is a key feature contributing to the attractiveness of Luxembourg as a major hub for European and global private equity transactions – many lenders insist on Luxembourg borrowers and will even have their preferred form of Luxembourg law governed security documentation.

IV REGULATORY DEVELOPMENTS

Many of the domestic deals in Luxembourg are subject to regulatory approval and involve commitments being given by the private equity buyer to the relevant regulator. Sale processes are often specifically adapted to accommodate the requirements of the CSSF (the financial sector regulator) or the CAA (the insurance sector regulator) regarding client information. Electronic data rooms must be used carefully, and they are often combined with physical data rooms and staggered disclosure. Otherwise, sale processes involving Luxembourg targets will be familiar to the international buyer – there are few local idiosyncrasies. Warranty and indemnity insurance is increasingly popular.

From a tax perspective, the Luxembourg government has announced a welcome amendment to the law; namely, a modification to the law introduced at the beginning of 2019, with a retroactive effect as of 1 January 2019, to allow Luxembourg taxpayers to opt for the application of the interest limitation rule at the level of a tax unity.

V OUTLOOK

Looking ahead, we expect to see Luxembourg continue to develop as a private equity hub. While domestic private equity M&A activity is unlikely to increase dramatically, because of the limited number of potential targets (notwithstanding the high levels of interest from potential buyers looking at assets in the funds sector), the buying and selling of Luxembourg holding companies and the general use of Luxembourg investment platforms for deploying capital in private equity deals is accelerating, as is the size of managers’ teams on the ground and the use of Luxembourg law in transaction documents. We expect these trends to continue.
Chapter 11

MEXICO

Andrés Nieto Sánchez de Tagle

I OVERVIEW

i Deal activity

Private equity in Mexico is focused on investment in primarily small and medium-sized companies that are not traded on the stock market, with horizontal investments made over three to seven years, during which time investors seek to build the companies up to later sell their investment either to a strategic investor or, in some cases, through a public tender offer on the Mexican stock exchange. Both public and private entities try to create incentives for a more open culture towards private equity. Nonetheless, it is still seen as an objective that is hard to reach for most small companies, or as leading to a loss of control for family run companies, so it is not used as often as desired.

These perspectives, among other factors, mean that private equity in Mexico has less importance than it has in other emerging countries. However, in recent years, Mexico has grown rapidly in this area, and since 2015 it has become, along with Brazil, according to a special report by Financier Worldwide magazine, one of the most popular countries for private venture capital in Latin America.

One noteworthy reason for the increase of investment activities in Mexico has been the steady growth of gross domestic product (GDP) during recent years, and the several aggressive pro-growth reforms made since 2012. According to recent studies by the Organisation for Economic Co-operation and Development (OECD), prices in the country have decreased significantly, especially in the telecommunications sector, where the prices of mobile telecommunications (using the OECD mobile broadband basket comparison), fell by 61 per cent in the medium-usage category and 75 per cent in the high-usage category. Consequently, Mexico is becoming a more competitive market.

Furthermore, the Mexican authorities continue to legislate to make the country more competitive, and to strengthen and promote the growth of private investment, both national and foreign, in sectors to which there was previously no access. The government’s support for investment is already showing results, giving Mexico a clear advantage over other emerging-market peers.

This support can be seen in both the opening up of the energy sector to private investment (with committed investments having now reached more than US$175 billion in this sector, according to the OECD) and the creation of public funds to encourage the development of small and medium-sized companies. However, one of the primary challenges facing private

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equity is the reluctance of entrepreneurs and families managing many of the companies in Mexico to surrender control of their companies by accepting external investment by capital funds as partners or shareholders. Despite this adverse ‘cultural’ issue, private equity has been rapidly gaining importance in the country in the past few years.

The private equity industry has grown at a double-digit compound annual growth rate of 21.6 per cent since 2005, reaching over US$58 billion in capital commitments to venture capital, growth capital, leveraged buyout, real estate and infrastructure, and energy. Moreover, trust in alternative funding schemes has soared recently because of financial stability and increasing return rates. Financial growth and well-publicised successes, together with the latest amendments to the applicable laws, have broadened the base for private equity operations. The range of opportunities for private equity has expanded beyond the usual targets to incorporate a wide variety of projects. Consequently, the possibilities for aggressive expansion in the future seem very promising.

The greater part of private equity in Mexico comes from foreign investors, and there is, therefore, a tendency to engage in cross-border transactions. Mexico’s regulations tend to generate interest from global investors, and there are several industries that offer great opportunities for private equity investments. The energy sector is a good example, with regulatory benefits for cross-border transactions. The ending of the state monopoly in this sector following the 2013 energy reform, and the introduction of new regulations, have opened the sector up to private investment, allowing Mexico to become an attractive market for private equity.

Apart from the high-profile energy sector, other sectors such as health, telecommunications and consumer goods and services have also been targeted by both national and international investors interested in entering the Mexican market. Mexico has also made a series of significant reforms in telecommunications that have created a more attractive environment for private equity.

The fintech industry in Mexico has also become the subject of considerable growing interest. Following publication of the Fintech Law and the first and second rounds of its implementing regulations, covering crowdfunding, electronic payments, fund institutions, cryptocurrencies and financing operations carried out using new models, the fintech sector has been targeted by both national and international investors interested in entering the Mexican market, and has become a focus for private equity activity and investments in the country.

The development of new ways to carry out transactions in Mexico is undoubtedly making the Mexican market more attractive to foreign investors. Additionally, private equity M&A in the country is also expected to continue growing, fuelled by expectations that exit options will increase in the next few years.

As markets and needs grow, there is an equivalent need for managing parties to be able to respond rapidly and efficiently. Consequently, private equity sponsors that may add value with hands-on expertise and many other management skills are now preferred to pure capital investments. Generally speaking, private equity sponsors are not subject to specific supervision or treatment under the law, although certain matters require regulatory compliance, and tax issues must be addressed carefully because of the nature of these operations. Nonetheless, every financial participant must be aware of the importance of having well-prepared legal counsel for the design and review of operations. From the supervision point of view, authorities do not intervene in the day-to-day business of a company as long as there has been careful planning and design in the early stages of the project, and only in regulated industries.
In other schemes, as with publicly listed corporations, issuers of capital development certificates (CKDs) are subject to stricter regulation relating to disclosure, directors’ duties, corporate governance and minority rights. Hence, the need for legal advisers is also increasing, and more specialisation is required. In the area of private equity, the main challenges facing legal advisers in Mexico are knowing and understanding the practical requirements of the legal structures and of the investors and other parties involved in private equity transactions, as well as being familiar with the Mexican company culture. As previously mentioned, many Mexican enterprises are family businesses and tend to be reluctant to surrender control of their companies. There are also various challenges to be overcome in international transactions that have implications regarding labour, finance and other areas.

ii Operation of the market

Mexican companies looking to obtain funding to develop their business can do so primarily through:

- a capital contributions from partners or shareholders;
- b government financing;
- c private equity;
- d project finance;
- e financing by banking institutions; and
- f financing through the securities market.

Each of these options requires the preparation and negotiation of different legal instruments necessary to carry out these types of transactions, and the time required will depend on the complexity of each transaction.

Mexico’s private equity industry is basically composed of funds with different investment strategies. Generally speaking, there are four types of funds: private equity funds, venture capital funds, real estate funds and infrastructure funds.

Private equity funds normally utilise one of the following investment strategies:

- a growth, through investing in companies looking for expansion, entering new markets or financing strategic acquisitions;
- b leveraged buyouts, namely specialising in acquiring companies via external capital;
- c mezzanine capital, which allows for more flexibility as fewer guarantees are required (meaning more risk and higher costs); or
- d distressed or special situations, namely investing in companies or assets facing difficult situations.

Venture capital funds seek to invest in companies in their early stages, known as start-ups. Real estate funds invest specifically in real estate for residential, touristic, commercial or industrial use. Finally, certain funds specialise in infrastructure for transport or energy.

Typically, there are several stages in the creation of a private equity fund. First, the interested investors would generally form a team to identify and structure the fund, and plan the process for investment and exit or disinvestment. The people concerned, therefore, have to establish a clear investment strategy, which will vary depending on, inter alia, the investment strategy or goal, the sector and participants, as noted above. They must then appoint an investment committee, which will be in charge of administering the fund. To finance the internal structure, funds can receive income from the following sources:
management fees (generally from 1.5 to 2.5 per cent, depending on the size of the fund and the sector); carried interest or carry returns that correspond to the fund administrator; and other sources.

Once the goals have been established, the team to achieve them appointed and the internal financing scheme settled, the next step is fundraising. This step is usually fairly complicated and might take a long time, as different scenarios must be considered in the planning phase in case goals are not achieved within the expected time frame. Fundraising implies a process of advertising and selling to investors (natural persons, corporations, other funds, etc.), and the administrator of the fund is in charge of this process.

After the fund has secured the commitment of the necessary investors, it can proceed to the third step: the legal formalisation of the work done to date. This means, basically, incorporating the fund operator and the investment vehicle, and the structure will vary (again this will depend on a large number of factors – see Section II).

Finally, the fourth step is the investment phase. The process usually starts with the administrator of the fund and the representative of the company in which the fund will invest signing a letter of intent, to be followed by a due diligence process and the signing of a term sheet in the event that all is found to be satisfactory.

The due diligence process consists of, among many other factors, a strategic analysis of the company's business model, a market analysis, study of the distribution and offer of products, economic competition, financial standing of the company, investment needs and legal implications. Conducting a proper due diligence process is a key step to making a well-informed decision. By means of the due diligence checks, the administrator should have a clear overall picture of the company, the market in which it competes, its needs, the risks it faces, and the costs, goals, etc., affecting the business. Legal advisers are also key players in this process, as they guarantee, inter alia, the validity, adequacy and legality of the company, its businesses and licences. An in-depth study of the situation of the company may prevent future problems. As mentioned above, once all this is found adequate and fitting within the fund’s investment parameters, the company and the fund will establish the investment terms and sign a term sheet, which normally expresses the type of investment, dividend rights, voting rights, preference in payment, protection clauses, conversion options, future contributions, selling clauses and any other terms that the parties agree upon.

Depending on the type of investment, once the fund has completed the above-mentioned steps and the investment is made, the administrator would normally get involved in the operation of the company. For example, some administrators ask to become board members, or to be granted authority to designate their own board member or members, depending on their total participation in the company – in short, whatever is deemed to be required, and always keeping in mind the common goal of increasing the company’s value as much as possible within a given period.

To close the cycle, the fund must establish, inter alia, an exit strategy, deadline, conditions and policies with very clear terms that should always be respected.

A key factor in achieving all of the above-mentioned goals, and in the whole process, is ensuring that the fund is run correctly. In this context, investors in private equity funds have the most important role as controlling agents. Therefore, the investors and the fund meet regularly, with the investors receiving reports at established intervals and undertaking other activities to promote a good relationship between the investors and the fund.

Another key feature of private equity transactions is ensuring that management, which will be asked to deliver on the company’s business plan, are appropriately incentivised.
and aligned with the sponsor. This is typically achieved with incentive equity arrangements put in place at the time of the sponsor’s acquisition of, or investment in, the company. There are different schemes, including sweet equity, performance rights, and options that are exercisable into ordinary or profit interests. The choice between these alternatives depends on the type of private equity fund and is often driven by exit structures and tax considerations.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Mexico does not have any specific laws applicable to private equity. Hence, private equity transactions are regulated indirectly through the commercial, civil and securities law and regulations. Nevertheless, legal developments have taken place as the market has continued to evolve. For example, the 2014 financial reform acknowledged CKDs, legal instruments that allow asset managers to channel the resources of domestic pension funds (AFOREs, which previously could only legally invest in publicly offered securities) into projects. Hence, through CKDs, AFOREs now have a way to invest in private equity.

The regulation of CKDs has been amended several times to adapt to the needs of the market and to make the process easier and faster. Along with CKDs, which have been successful, there have been other legal developments in favour of private equity, namely the recently developed CerPIs and Fibra E financing instruments (see Section IV). In less than 10 years, these have raised around 566.9 billion Mexican pesos, which represents 2.4 per cent of Mexico’s GDP for productive and infrastructure activities.

As detailed in Section I, the third step in the process of creating a fund is designating the fund operator and an investment vehicle. Since there is no specific regulation of the matter, generally the fund’s operator is incorporated as an SA or a SAPI, which are regular corporations that can enter into shareholder agreements and have drag-along and tag-along rights, unlike other types of companies in which these agreements or rights are not valid in court. After incorporating the operator, the fund must establish the investment vehicle, examples of which include:

a a limited partnership;
b a private equity investment trust (FICAP) with a maximum duration of 10 years, whose purpose is to invest in or finance Mexican-resident companies not listed on the Mexican stock exchange;
c a non-business trust, which has fewer restrictions than a FICAP; and
d a capital investment company, which might be inefficient for certain purposes on account of inherent legal restrictions, such as not permitting first-refusal rights.

Consequently, within this framework, as in any other type of company, national or foreign sponsors would have to ensure control over their investment through, inter alia, shareholders’ agreements, assuring majority percentages and board representation. Negotiations will depend on the amount to be invested and the needs of the company; in other words, on the leverage each party can exercise on its own behalf.

Before investing, consideration must be given to understanding the limitations applicable to foreigners. According to the Foreign Investment Law, foreigners are subject to certain limitations as to their ownership, control of, and participation in, companies and sectors (usually related to national security). There are also certain sectors they cannot invest
in at all, as these are exclusively reserved for Mexicans: for example, domestic passenger, tourist and freight land transport, development banking and certain professional services. In other activities, foreign participation is limited to a maximum percentage.

That said, Mexico is a fairly open market and the aforementioned limitations are relatively few and specific. As previously mentioned, the legal regime has been created with the specific intent of facilitating foreign investment in the country and, notably, Mexico has many commercial treaties and agreements with other countries; furthermore, indications are that the trend is towards maintaining this situation.

ii  Fiduciary duties and liabilities

The fiduciary duties and liabilities of sponsors are no different than they would be in any other business relationship. Their scope will first be drawn up and delimited in the letter of intent. Once the investment agreement is reached, they will be set in a term sheet or a shareholders’ agreement, depending on the existing structure and the steps to follow to make the investment.

There are several crucial elements in every relationship that may give rise to conflicts or problems in the future. Private equity funds usually have relatively short to medium-term objectives, which might not coincide with the company’s objectives. This said, when negotiating, it is very important that the deadlines and objectives of each party are well known, if not aligned. What might interest one party in the short term might not interest the other party, but might be complementary, because when the time comes to exit, the fund might seek a completely different strategy to exit the investment motivated by different objectives and goals, and it will probably be facing different responsibilities before its own investors.

The most common ways for a private equity firm to exit an investment are an initial public offering, a secondary deal (acquisition, sale), repurchase by the promoters or, as a last-resort (and probably undesirable) scenario, a liquidation. The structuring considerations will depend on many factors, and every deal will be unique. However, common to all deals is the importance of bearing in mind that time is of the essence, and all requirements must be very carefully considered to avoid problems and misunderstandings; in addition, a disinvestment operation might take quite a long time.

Indeed, foreign investors should give particular consideration to matters from a timing perspective, as all the processes involving foreign companies might require extra time. Due diligence processes usually take longer, and verification of documents requires coordination between several parties, which always results in more time and money being expended. Otherwise, as previously mentioned, apart from certain tax considerations, Mexico is a fairly straightforward and dynamic country in which to invest and disinvest.
III YEAR IN REVIEW

i Recent deal activity

According to the Association for Private Capital Investment in Latin America (LAVCA), Caisse de Dépôt et Placement du Québec, a long-term institutional investor, acquired a minority stake in the Mexican pharmaceutical company Sanfer for US$500 million. This investment is one of the largest minority private equity transactions recorded in Mexico, and it will enable Sanfer to continue its expansion across Mexico and Latin America.

Despite a decrease in the number of deals in the infrastructure sector, Gran Ciudad, a fully integrated real estate company based in Mexico City, closed a real estate funding deal of US$313 million with equity commitments from Ivanhoé Cambridge, a global Canadian real estate investor, and from Citibanamex Afore, the second-largest pension fund manager in Mexico.

The fintech industry presented several deals during the past year. One of the key deals was the investment by SoftBank and General Atlantic in the Mexican fintech start-up Clip. This investment was part of a round that raised approximately US$100 million. In addition, SoftBank led a US$100 million investment in lending platform Konfio. These are two of the biggest investment rounds recorded in the fintech industry.

Moreover, Konfio raised a US$250 million debt round from Goldman Sachs and Victory Park Capital. According to LAVCA’s press release, ‘these agreements [together with Softbank’s investment] make Konfio one of the largest fintech companies in Latin America in terms of investments received and will allow the company to continue growing its lending business by providing loans to more than 25,000 small and medium-sized Mexican businesses’.

Private equity firms are looking at Mexican targets as a base from which to develop their Latin American business and are interested in Mexican firms already doing business in other countries. This results in very interesting projects that involve not only Mexican operations, but also other operations in other countries in the region. Overall, investments from 2000 to 2019 focused principally on energy, e-commerce, telecommunications and financial services. However, as mentioned in Section I, two more sectors are now gaining greater investment: health and consumer goods and services. In addition, private equity funds are tending to invest and raise capital through new financing instruments, such as CKDs, CerPIs and the FIBRA E.

ii Financing

Private equity activity in Mexico is increasing significantly as a result of several financial reforms in recent years. The government’s developments have had a favourable impact in the market, even promoting investment in sectors that were previously exclusively reserved for the state, such as the oil sector. In less than a decade, private investments have grown rapidly and they now multiply year on year. For the past four years, Mexico has been a leading market in

3 https://lavca.org/2019/08/19/cdpq-acquires-a-stake-in-sanfer-for-us500m/.
5 https://lavca.org/2019/05/06/general-atlantic-softbank-invest-in-mexican-payment-startup-clip/.
6 https://lavca.org/2019/12/03/softbank-leads-a-us100m-investment-in-konfio/.
7 https://lavca.org/2019/09/06/konfio-raises-a-us100m-debt-round-from-goldman-sachs/.

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Latin America for general partner investment; however, the market is still performing below expectations. Nonetheless, capital funds continue to grow within the market and regulatory reforms are expected to continue with the growth of private investment.

The structural reforms that have entered into force have already had consequences. The energy reform, for instance, has been closely followed by private equity participants because of the opportunities created by the opening up of this sector. Even though oil prices have fallen, benefits from the energy reform of 2013 have emerged in Mexico. Because of the opening up of this sector to foreign and private investment, it has assumed an important role in the country over the past four years. Capital funds have expanded their investment asset classes to include the energy sector in both direct majority acquisitions and minority-stake investments. Additionally, and as a direct result of the opening of these industries to foreign and private investment, both Petróleos Mexicanos and the Federal Electricity Commission, officially ‘productive state enterprises’, can now enter into alliances, associations or joint venture schemes with foreign investors to develop certain energy sector-related activities in the different downstream, midstream and upstream sectors. This will, in turn, play an important role in the market by allowing capital funds to participate in these types of transactions.

### Key terms of recent control transactions

In January 2019, Beamonte Investments, via its opportunistic industrial platform ‘Axman Holdings’, announced that it had acquired a majority stake in Arcaya SA de CV, a Mexican footwear manufacturer. Beamonte’s cash injection will be used for working capital needs and will allow Arcaya to acquire additional equipment, as well as develop its product pipeline and strengthen its client relationships. For 20 years, Arcaya has manufactured shoes for Julio de Mucha, a well-known Mexican fashion brand with clients in Europe and the United States, including many Fortune 500 brands.8

In February 2019, Rappi, a delivery platform based in Colombia and Mexico, acquired Payit, a Mexican blockchain-based payments platform.9 With this acquisition, Rappi will join the fintech ecosystem and will add fintech to the delivery and on-demand services that it already offers. In 2018, Rappi became one of the new ‘unicorns’ in Latin America, being valued at more than US$1 billion.

In October 2019, Uber Technologies, Inc, announced an agreement to acquire majority ownership of ALLVP’s portfolio company, Cornershop, the largest on-demand grocery platform in Latin America.10 This partnership will enable Cornershop to access millions of consumers on the Uber platform, facilitating its plans to launch into several new markets over the next year.

### Exits

One of the most common exit routes we have seen in the past few years is the transfer of the investor’s investment to another company; generally, a related company such as a competitor, supplier or client that finds strategic value in it. Additionally, we have also seen direct transfers to another capital fund and public stock offers on the securities market, as well as the sale of shares acquired by the investor to another shareholder of the company.

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Regarding venture capital transactions, the most common exit type in terms of the total number of transactions is strategic, but in terms of amount, M&A is the most common, representing around 90 per cent of the total amount registered, according to the Mexican Association of PE and VC Funds (AMEXCAP). The most common exit types for growth and leveraged buyout by number of transactions are strategic, asset sale and initial public offerings. For real estate, asset sale and strategic are the most usual exit types. Moreover, the most common exits types for infrastructure and energy are strategic and asset sale.

During 2019, there were several exits of note in the Mexican private equity market.

In March 2019, Alta Growth Capital announced the completion of the sale of Mexico’s leading trailer manufacturer, Fruehauf, to Fultra, a Mexican conglomerate focused on the trucking and transportation industry. According to LAVCA’s press release, ‘This was Alta’s first exit from its second fund, which helps capture a portion of the superior returns it is generating for its investors’.11

Also in March 2019, Nexxus Capital announced its full divestment from Harmon Hall Holding, SA de CV, a portfolio company from Nexxus Capital Private Equity Fund III. Harmon Hall was acquired by Talisis, a subsidiary of Grupo Topaz, a strategic investor in the Mexican educational sector.12

On 3 April 2019, Adobe Capital announced its divestment from Provive, making it the second portfolio company to exit from its first fund, Adobe Social Mezzanine Fund I. Provive is a Mexican urban regeneration company, which rehabilitates abandoned homes and fosters community involvement. The exit occurs following financing provided by an international bank.13

In May 2019, DILA Capital and Mountain Nazca Mexico exited Creze, a Mexico City-based financial services start-up for small businesses, through a sale to Polygon Fintech, a financial group focusing on Mexico’s unbanked population. This transaction represents DILA’s first exit from Fund III and Mountain Nazca’s third exit from Fund I.14

In November 2019, through its portfolio company Taco Holding, Nexxus Capital announced the closed divestment of Krispy Kreme Mexico, which was acquired by Krispy Kreme Doughnut Corporation, the brand’s global owner. The partial exit resulted in a return of liquidity to Nexxus Capital’s LPs.15

IV REGULATORY DEVELOPMENTS

Notable among the recent legal developments with relevance for the investing environment in Mexico were the introduction of the Fibra E, a real estate trust structure aimed at the energy and infrastructure sector, and CerPIs, investment project securitisation certificates. Fibra E vehicles are investment vehicles similar to Fibras (Mexican real estate trusts that have been successful in recent years) and can increase the financing of projects in the energy sector, while CerPIs are certificates issued through restricted public offerings, and whose issuance resources are used to finance projects and invest in stock, directly or indirectly through investment vehicles.

13 https://lavca.org/2019/04/03/adobe-capital-ignia-to-exit-mexicos-provive/.
In October 2016, the Fibra E vehicle Fibra Via issued by Pinfra concluded the first public offering in Mexico of 394.5 million energy investment trust and infrastructure certificates. The placement raised a total of 11,835.07 million pesos and was considered very successful because of its acceptance among investors. Regarding CerPIs, on 30 September 2016 the first CerPI was listed on the Mexican stock market by Mira Manager, a real estate company focused on the development of urban mixed-use communities in Mexico, for a maximum amount of 4 billion Mexican pesos, with the first issue raising 800 million Mexican pesos.

While CerPIs and Fibra E vehicles have not yet been widely used, these instruments have consistently gained in popularity and are expected to boost capital investments in Mexico.

Another noteworthy regulatory development became effective in January 2018, in relation to AFOREs. In an effort to broaden pension fund investment options, the Mexican authorities modified the investment regime to allow AFOREs to use mutual funds as investment vehicles. Although this area has seen some significant regulatory developments in recent years, the legal regime for private equity is expected to continue evolving.

V OUTLOOK

In recent years, private equity has steadily become a more competitive sector for investment in Mexico. Following reforms in various sectors and industries, such as energy, telecoms and, most recently, fintech, Mexico has become a leading market for investments in Latin America. Despite the uncertainty that some of the current administration’s policies might have generated in the past few months, there is a positive outlook for the Mexican private equity industry. Over the next year, we expect investments in the energy and infrastructure sector to continue to increase and the fintech industry to continue to consolidate as an important target for national and foreign investment. We also foresee an increase in the use of the recently developed financing instruments (CKDs, CerPIs and Fibra E) by private equity sponsors. If conditions remain the same, and the growth remains at levels recently seen, private equity will reach over US$80 billion by the end of 2020, according to AMEXCAP.
I OVERVIEW

i Deal activity

The Norwegian economy is to a large degree, directly or indirectly, exposed to the oil and gas extraction and related industries. The Norwegian economy was less affected than other countries by the consequences of the financial crisis of 2007–2008 and the subsequent sovereign debt issues in Europe, in part because of the income it derived from oil and gas extraction. However, the substantial reduction in the price of oil that started in 2014 (from US$115 per barrel in June 2014 to approximately US$30 at the start of 2016, since levelling out at around half of its 2014 high)\(^2\) had quite immediate effects in the Norwegian ‘real’ economy. This led to severely reduced investment activity, lay-offs of personnel and debt restructuring in the oil-related sectors. Although the sector has mostly successfully restructured to the new level of oil prices, investment activity has more recently seen signs of abating following the decision of some investors to ‘decarbonise’ their portfolios as part of their sustainability strategies. Future investor appetite for the sector will be important for its development. Lower investments may also drive up oil prices and potential return.

The perceptible reduction in deals in the Norwegian market towards the end of 2014 has persisted. With respect to investments made by funds advised by Norwegian sponsors,\(^3\) there was a sharp drop from top levels in 2016 of 12 billion Norwegian kroner to 8.5 billion Norwegian kroner in 2017, levelling out at 8.1 billion Norwegian kroner in 2018. There were no public-to-private deals (of any significance) in 2018 or 2019.\(^4\)

The number of private equity exits by funds advised by Norwegian sponsors continued its downward trend from 39 in 2017 (and 39 in 2016) to 31 in 2018.\(^5\)

In 2017, no private equity exits were made in the form of an initial public offering (IPO). In 2018, government-backed venture investor Investinor (see below) partially exited poLight through an IPO, as was the case for fitness group Sats Elixia, previously controlled by Altor. There has been a lasting decline in the number of exits being made in the form of an IPO, mirroring a decline of the Oslo Stock Exchange as a source for risk capital. This trend may indicate that IPOs are not seen as being as viable an exit route as previously in

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1 Peter Hammerich is a partner and Markus Heistad is a senior lawyer at BAHR.
2 Official Brent Oil prices.
3 Definition by the Norwegian Venture Capital & Private Equity Association (NVCA).
4 BAHR AS internal study.
the Norwegian market, except in exceptional cases. In 2019, Oslo Børs was acquired by the French Euronext group, and will likely become more integrated with the Euronext capital market infrastructure.

As at the start of 2020, a total of 167 Norwegian alternative investment fund managers were registered or authorised by the Financial Supervisory Authority of Norway, compared to 147 the year before. Approximately half are private equity managers. The exact number of alternative investment funds established in Norway is unclear, as some private equity funds will still be covered by the grandfathering rules under the Alternative Investment Fund Managers Act (the AIF Act), implementing the EU Alternative Investment Fund Managers Directive (AIFMD). The recent increase in numbers is likely also related to the fact that the regulator has stated that it views single asset funds (which has been an important asset class within real estate in Norway) as within the scope of the AIF Act.

From the point of view of investing activity, the Norwegian private equity scene may be divided into five main categories. The first category consists of (in a Norwegian context) relatively large generalist private equity investors, such as FSN Capital, Norvestor Equity and Herkules Capital. The second category consists of sector-specialist investors, such as HitecVision, Energy Ventures and Hadean, the first two focusing on technology and assets connected to the exploration of oil and gas, and the latter a healthcare specialist. In the third category are a number of smaller sponsors in the venture and seed capital segments, such as Proventure and Sarsia.

As a fourth category, some Stockholm and Helsinki-based managers are active in the Norwegian market to the extent of having established offices in Norway (e.g., EQT, Altor, Nordic Capital and Northzone). Increasingly, international private equity funds are active in the Norwegian market. A notable example is Partners Group's acquisition of CapeOmega, an owner-participant in the Gassled transportation, storage and processing infrastructure for gas from the Norwegian North Sea in 2019.

The fifth category is made up of government-backed actors, and chiefly Argentum Fondsinvesteringer AS. Argentum is a government-owned investment company investing in private equity. Argentum is active both in the primary and secondary markets, and in completing co-investments with private equity funds, and it is a significant investor in most Norwegian and Scandinavian venture and private equity funds. Argentum has expanded its geographical investment area outside Scandinavia. In the venture segment, the government has established Investinor AS, an investment company for venture investments. As at the third quarter of 2019, the investment portfolio of Investinor AS amounted to 2.5 billion Norwegian kroner. Investinor has financial assets and a commitment from the government amounting to 4.2 billion Norwegian kroner, and had its equity increased through a capital injection of 350 million Norwegian kroner by the government in 2019.6

There were no new fund sponsors in Norway in 2019.

## Operation of the market

### Management incentive schemes

A key element of private equity investing is appropriate incentive schemes aimed at key personnel both at the fund (sponsor) and portfolio company levels.

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6 Source: Investinor AS, Q3 2019 report.
In Norway, incentive schemes at the sponsor level, aimed at key personnel of the manager, have traditionally been equity-based and modelled on traditional incentive schemes in the international private equity industry. The specific structuring of sponsor management equity schemes will vary from case to case depending on, inter alia, the relevant legal framework applicable to the manager, and on the participants and choice of investment model. Norwegian fund managers authorised under the AIF Act are subject to remuneration rules that may affect incentive schemes that are not investment-based (carried interest).

At the portfolio company level, it is common practice for private equity funds to require key employees of a portfolio company to reinvest alongside the fund in connection with a fund’s acquisition of the company. Incentive schemes aimed at such key employees have evolved over the past years, migrating from option-based and bonus-based models to almost exclusively investment-based models.

In some cases, key employees invest on the same terms as the fund, with their investment exposed to the same risk. However, it is not uncommon that the employees’ investment implies greater risk than the fund’s investment, and also that the investment has the potential for a higher relative return. This is normally achieved by establishing different classes of shares in the company, the financial terms of which are often similar to the terms that are common for private equity funds (i.e., a carried-interest model). A common structure is to establish two classes of shares with different risk and return profiles. The share class with lower risk and potential for return (preferred shares) is predominantly subscribed by the fund, while the share class with higher risk and potential for return (subordinated shares) is subscribed by leading employees and, in some cases, the fund.

The exact terms of leading employees’ investments differ between funds and individual portfolio companies. It is, however, possible to identify certain basic principles that apply in some form in most cases. For instance, it is customary that the terms applicable for the preferred shares state that the fund shall be entitled to receive the entire amount it has invested, plus a predefined return on the investment (the preferred return), before the subordinated shares become entitled to any distributions, hence the greater risk on the employees’ investment. After the fund has received its preferred return, each subordinated share will be entitled to receive a higher amount of excess distributions than each preferred share, hence the higher potential for return on the employees’ investment.

Normally, leading employees that own subordinated shares are subject to certain restrictions and obligations that do not apply to preferred shares. These include transfer restrictions and obligations such as lock-up and standstill for a predefined period, right of first refusal for the fund and drag-along obligations (employees normally also have tag-along rights). It is also common that leading employees are subject to good-leaver and bad-leaver provisions, and enter into restrictive covenants such as non-compete and non-solicitation undertakings, and restrictions on other business interests and engagements.

On 1 January 2017, new legislation concerning non-compete clauses and certain types of non-solicitation clauses in employment contracts entered into effect. Under these rules, non-compete and non-solicitation clauses were made subject to several limitations in employment contracts. Among other things, non-compete clauses require compensation and such clauses may not extend longer than 12 months from the end of the employment. Exceptions may be agreed for the CEO (only). These new restrictions mean that non-compete and non-solicitation clauses should be addressed fully in the shareholder agreements for management incentive schemes and be linked to the status as an investor.
Private equity divestments

The terms of divestments made by private equity funds will differ from case to case and generally between segments (venture, growth, buyout). The attractiveness of the target company will often be a dominant factor as to whether a sales process runs smoothly and quickly. Exits through IPOs are fewer now than prior to the financial crisis. Consequently, most exits take the form of a secondary sale to other private equity investors or trade sales to industrial actors.

As a general rule, divestments by Norwegian funds are made through structured auction processes targeting a limited number of potential buyers. It is good practice for the manager to formulate exit plans in connection with the original investment in the portfolio company, and also throughout the term of the investment as the relevant portfolio company and market conditions develop. For authorised AIFMs, this is a legal requirement. Buyers will, depending on the target company in question, consist of industrial actors or other funds, or a combination thereof. The time and effort necessary to complete a divestment, as well as the terms that may be obtained by the divesting fund, will vary greatly depending on the size and other characteristics of the portfolio company and the prevailing market conditions.

Authorised AIFMs (when investing in assets of limited liquidity preceded by a negotiation phase, as is typically the case for private equity investments) are required to establish and update a business plan for the investment in accordance with the duration of the fund with a view to establishing exit strategies as from the time of the investment. While most private equity fund managers would expect to put such a plan in place as a fundamental aspect of the investment process, the AIFMD requires this as a statutory duty.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The investment objective of private equity funds is generally to achieve superior returns through control in its portfolio companies. In this section, we provide a brief description of the legal framework for a control investment in Norwegian public and private limited companies. Our discussion is limited to equity investments (we do not discuss asset transactions).

Listed companies are a subset of public companies. The regulatory regime applicable to takeover offers on shares differs significantly, depending on whether the target company is listed on a regulated market or not. Acquisition of controlling stakes in listed companies triggers particular requirements.

Norway has implemented the EU Takeover Directive through rules in the Norwegian Securities Trading Act, which applies to Norwegian and (subject to certain exemptions) foreign companies listed on a Norwegian regulated marketplace (currently the Oslo Stock Exchange or Oslo Axess). The takeover rules distinguish between voluntary and mandatory offers. A voluntary offer, if accepted by the recipients of the offer, triggers a mandatory offer obligation for the buyer. A mandatory offer for the remaining shares in the target is triggered if the buyer (either through a voluntary offer or otherwise) becomes owner of more than one-third of the voting rights in the target (with repeat triggers at 40 and 50 per cent). Further, Norway has implemented the EU Transparency Directive through rules in the

7 Directive 2004/25/EC.
8 Directive 2004/109/EC.
Norway

Norwegian Securities Trading Act, requiring major shareholding notifications. Norway has yet to implement the revised EU Transparency Directive (as amended through Directive 2013/50/EU). This is expected in 2020.

In the case of an unlisted target company (whether the target is a public or private limited company), the buyer is to a large extent free to determine the process pursuant to which a takeover shall be executed, subject to what may be agreed on a contractual basis with the target or the target company’s shareholders.

EU fund managers that are authorised under national legislation implementing the AIFMD and non-EU fund managers that hold a marketing authorisation in an EEA Member State are subject to certain reporting requirements when investing in unlisted companies that are not small or medium-sized enterprises (SMEs).⁹ Such managers shall notify the regulator whenever the proportion of voting rights of the non-listed company held by the fund or funds under management reaches, exceeds or falls below the thresholds of 10, 20, 30, 50 and 75 per cent. Additional disclosure requirements are triggered upon acquiring control in the relevant company (which also applies when the company is listed). Investments by funds managed by EU fund managers authorised under national legislation implementing the AIFMD or by non-EU fund managers holding a marketing authorisation in an EEA Member State in unlisted (non-SMEs) and listed companies where the funds have acquired control of the company are also subject to rules concerning asset stripping. These rules contain certain restrictions on distributions, capital reduction, share redemption and acquisition of own shares for a period of 24 months from the acquisition.

According to Norwegian merger regulations, all mergers and transactions involving acquisition of control (concentration) must be notified to the Norwegian Competition Authority if the undertakings involved in the transaction have a combined annual turnover in Norway of 1 billion Norwegian kroner or more, and at least two of the undertakings concerned each has an annual turnover exceeding 100 million Norwegian kroner. An automatic standstill period applies to all concentrations subject to the notification requirement, until the Competition Authority has concluded its handling of the case. If the transaction is of a magnitude that requires merger clearance at EU level, the Norwegian filing requirements are suspended and absorbed by the EU rules.

Acquisition of substantive holdings or control in a target company may also trigger other filing, concession or approval requirements under Norwegian or foreign legislation. These aspects must be assessed on a case-by-case basis. In Norway, this applies within, for example, the financial sector, fisheries, oil extraction and certain infrastructure, such as production or transfer of electricity.

The above rules apply independently of the jurisdiction of establishment of the investing fund. However, the jurisdiction of establishment of the investing fund will be among the considerations relevant to the choice of structuring of an investment to obtain a structure that is suitable from the point of view of the business and exit plans for the target company, as well as the prevailing tax laws.

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⁹ Enterprises that employ fewer than 250 persons and that have an annual turnover not exceeding €50 million, or an annual balance sheet total not exceeding €43 million, or both.
**Fiduciary duties and liabilities**

Private equity sponsors or managers are not subject to any specific fiduciary duties or similar duties to other shareholders in portfolio companies. However, Norwegian company law provides for shareholder minority rights in Norwegian public and private limited companies.

Minority shareholders in Norwegian public and private limited companies are conferred certain rights under Norwegian company law. The most significant restriction upon majority shareholders is the principle of equal treatment. This implies that the majority shareholder ‘cannot adopt any resolution which may give certain shareholders or other parties an unreasonable advantage at the expense of other shareholders or the company’.10

With respect to transactions with shareholders, the principle does not mean that all shareholders have to be treated equally at all times. Generally, differential treatment is acceptable if this can be justified based on objective grounds and the best interests of the target company as a whole.

Majority shareholders that are private equity funds should be aware that the Norwegian rules on financial assistance became more flexible with effect from 1 January 2020. The changes imply, inter alia, that an EEA or EU-based parent company now may acquire shares in a Norwegian company with financial assistance from such company without a limitation equal to such company’s dividend capacity (which is the general rule). The exemption applies irrespective of whether the parent company already is or becomes a parent company due to the transaction to which the financial assistance relates. Procedural requirements must still be followed, and the financial assistance must be on market terms.

In the case of payment of financial assistance to a group company, the minority shareholders may claim payment of an equal dividend. If the general meeting decides not to pay out a dividend, the minority shareholders may challenge this decision in court.

Minority shareholder rights will normally be supplemented by the more specific provisions of a shareholders’ agreement between the private equity fund and the minority shareholders (e.g., members of management) concerning rights at exit, etc.

**Potential liabilities for majority shareholders**

Norwegian limited company law provides for the liability of board members, members of management and shareholders for losses in the hands of the company in the event of negligent or wilful acts or omissions. The provisions of the limited company acts only provide for damage suffered by the company, and not by third parties (although third parties may, in priority, file claims on the company’s behalf).

Shareholders of a limited company may also be held liable for claims by third parties (piercing the corporate veil) in some cases. The legal basis for such claims is based on unwritten and customary law and is, to our knowledge, without legal precedent in Norway. However, case law provides that there are circumstances where the court will be prepared to come to the conclusion that shareholders are personally liable. This does not, in itself, abolish the company’s position as a separate legal entity; rather it is a form of shareholder liability. Although each case will depend on the court’s assessment of the particular circumstances, the court has come to such conclusions where, inter alia, a shareholder or secured creditor has a right of control over the company so that the company is in reality not organisationally or financially independent, as required by the Norwegian private limited companies act, the

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company has been under-capitalised compared to the financial risk involved in its operations for a long time (under-capitalisation may not in itself be a legal reason to pierce the corporate veil, but may indicate the company is not sufficiently independent of its owners) or the company’s funds have been used against its interests to benefit its shareholders.

**Rights of stakeholders**

As a general rule, Norwegian law does not confer any legal rights on other stakeholders that are legally binding upon the members of the board of directors of a limited company. The obligations of the board members (their fiduciary duties) are to the company and to the shareholders.

**Structuring exits**

Private equity investments are by nature temporary, and any acquisition by a private equity fund is made with the objective of a future exit. Acquisitions will normally be organised with the exit in mind, including measures to avoid complications due to minority shareholder rights (discussed above). Authorised AIFMs are required to adopt exit plans in connection with the original investment in the portfolio company and also update them throughout the term of the investment.

The time and effort necessary to complete a divestment, as well as the terms that may be obtained by the divesting fund, will vary greatly depending on the size and other characteristics of the portfolio company and the prevailing market conditions. Depending on the development of the relevant portfolio company or the prevailing market conditions, an exit may not be made as initially planned or set out in the exit plan; the manager may also identify more commercially interesting forms of exits at a later stage. This implies that an exit will normally require bespoke structural and legal measures.

With the exception of general contract, company, tax and competition law, few general rules govern an exit of a portfolio company. If an exit is made in the form of an asset sale, then labour law will be relevant, as the employees of the business to be transferred are conferred certain rights under Norwegian labour law. Under current Norwegian tax legislation, equity transactions will normally be treated more favourably than asset transactions.

### III YEAR IN REVIEW

#### i Recent deal activity

Following an all-time high in 2016 of 11.9 billion Norwegian kroner invested by funds advised by Norwegian sponsors, led by investments in the buyout segment, the figure declined to 8.5 billion Norwegian kroner in 2017 and 8.1 billion Norwegian kroner in 2018.11 Numbers for 2019 are not yet available.

There were few large transactions made by Norwegian private equity sponsors in 2019. Norvestor was among the first Norwegian sponsors to carry out a roll-over exit of IT company Cegal, spun out from their fifth fund to a special purpose vehicle managed by Norvestor.

The long-term trend seems to be for transactions that are largely Nordic-centric, with Nordic private equity sponsors typically investing in the Nordic countries, followed by US and UK actors. The telecoms, business services and petroleum sectors dominate transactions.

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overall. For a period following the fall in oil prices, retail was also an attractive sector for private equity investors. During 2018, a number of retail chains began facing financial difficulties, a trend that has increased in strength in 2019 leading to several bankruptcies of high street retail chains that are also private equity owned (e.g., beauty products chain Vita).

ii  Financing

One of the main consequences of the financial crisis and the ensuing sovereign debt problems of European and other countries has been a relative decline in the availability of banking finance for private equity transactions and similar transactions.

Traditionally, Norwegian sponsors have leveraged buyouts to a lesser degree than sponsors in other jurisdictions. In addition, Norwegian banks have been less affected by the market turmoil since the financial crisis than many European counterparts. The relatively minor role of non-bank financing is also related to the fact that lending is a regulated activity in Norway, which only banks and regulated financing undertakings may carry out. This means that Norwegian private equity funds have been affected to a somewhat lesser degree by the shifting credit market. The main source of finance in leveraged acquisitions is therefore still bank financing, but mezzanine financing has been used in some deals.

Terms for bank financing are highly standardised, but the content of covenants will differ from case to case based on, inter alia, the financial position and business of the target company.

iii  Key terms of recent control transactions

The terms of control transactions made by Norwegian private equity funds will vary greatly. In public-to-private deals, the rules on voluntary and mandatory bids, as well as a (normally) fragmented shareholder base, will mean that few terms will be set in such transactions.

In purely private transactions, terms will as a rule be confidential. The disclosure rules under the AIF Act with respect to acquisitions of control, applicable to certain AIFMs, do not require the disclosure of the terms. However, the timing of such acquisitions may become public knowledge faster than before. Norwegian private equity sponsors will consistently structure deals and set terms to obtain control in the portfolio companies with a view to exercising active ownership in the portfolio investments. As a rule, sponsors will seek to obtain control through a majority stake (50.1 per cent or higher) or through shareholders’ agreements granting the sponsor the right to appoint the majority of the board. Such shareholders’ agreements will routinely contain provisions concerning drag-along and tag-along rights, to achieve an appropriate exit, as well as to accommodate co-investment opportunities for management.

iv  Exits

The downward trend in investment activity is also reflected in the exit activity. The number of exits by funds advised by Norwegian sponsors has declined from 79 in 2013 (the most recent high point) to 43 in 2017 and 31 in 2018.12

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IV REGULATORY DEVELOPMENTS

In Norway, the AIF Act, implementing the AIFMD, came into force on 1 July 2014. Before that, private equity funds were outside the scope of any specific regulatory regime in Norway. Now, the AIF Act regulates management of private equity funds, and the marketing of interests in such funds. The majority of Norwegian private equity managers have assets under management below the threshold values requiring authorisation (€100 million or €500 million, depending on the fund terms). A number of managers are affected by the authorisation requirement, which is also triggered by cross-border management or marketing, or when marketing units in funds to non-professional investors in Norway, while some have elected to operate on a purely offshore basis with Norwegian advisory hubs.

During the past year, the Financial Supervisory Authority of Norway (FSAN) has proven more active, having both issued a circular on the applicability of the AIF Act on single asset funds and taken a more acute interest in the distinction between management and advice for sponsors with – relative to offshore management – large Norwegian advisory companies. The circular is primarily aimed at single asset funds making real estate investments but would apply similarly to co-investment funds and similar structures.

In Norway, private equity funds are still unregulated at the fund level. Although the AIF Act is aimed at managers only, certain provisions have effect at the fund level. This concerns primarily the requirement to appoint a depositary, but also reporting and disclosure requirements. On 15 January 2019, the Ministry of Finance initiated a public consultation on the implementation of the amendments to the EU Regulation on European venture capital funds (EuVECA), the EU Regulation on social entrepreneurship funds (EuSEF) and delegated regulation under the EU Regulation on long-term investment funds (ELTIF). None of the main regulations have entered into effect in Norway yet, and an amendment to the Financial Undertakings Act will be required to allow such funds to provide loans. The rules will, when implemented, introduce these regulated fund types in Norway. With respect to EuVECA and EuSEF funds, Norwegian registered managers will also be able to market interests in such funds to non-professional investors without being authorised under the AIF Act, in contrast to the current situation.

Authorised and registered managers established in Norway are supervised by the FSAN. The FSAN also has oversight over activities of non-Norwegian managers following marketing authorisations under the national private placement regime. The FSAN has, so far, shown limited concern for the investment activity and transactions carried out by funds managed by managers under its supervision. This seems to be a policy choice, as the primary focus of the FSAN has been on investor rights and fair treatment of investors. The FSAN is, however, concerned with financial stability and market integrity, but it has yet to pursue any matters related to transactions in unlisted instruments. The FSAN will typically carry out its duties through inspections of premises or document-based inspections. In the case of non-Norwegian actors, the FSAN will typically consider whether they have the proper

regulatory authorisation to carry out any regulated activities in or into Norway. With respect to investing, this will typically relate to the question of providing loans to Norwegian debtors, as this is a regulated activity (see Section III.ii).

There is otherwise no specific regime with respect to private equity transactions, which are legally no different from transactions between any other parties. The structure of private equity funds may, however, have consequences with respect to their position under competition law. Further, private equity investors as major shareholders in Norwegian companies in the financial sector (which require a prior authorisation) are a somewhat novel development. Regulators may, therefore, be stringent about applicants meeting documentation requirements when filing necessary applications.

V OUTLOOK

Notwithstanding the market conditions affecting all investors, private equity investors are especially dependent upon professional and successful deal sourcing to be able to deploy committed capital and make divestments on optimal terms upon the prospect of the termination of a fund.

In the Nordic region, several private equity sponsors have significant amounts of uncalled capital, and this has – along with lower interest rates – raised prices for attractive targets. Norwegian insurance companies and pension funds are now both subject to Solvency II investment rules (since 2016 and 2019, respectively), and should – all else being equal – allocate more of their portfolios to long-term investments such as private equity. It remains to be seen how this will develop and whether the market will cater to such investors and provide the sought-after returns. Such investors could be expected to have extensive reporting-quality requirements (to satisfy Solvency II look-through rules) as well as environmental, social and governance (ESG) requirements.

The relative importance of bank financing over other financing sources may change going forward. Upon transposition of the EuVECA and ELTIF Regulations, the types of funds affected will be allowed to provide loans (within certain limitations). Norway has implemented the Capital Requirements Directive IV and the Capital Requirements Regulation with effect from 1 January 2020 (with certain transitional rules). This includes the SME supporting factor – providing for a lower capital charge for exposures towards SMEs. The government has, however, proposed to increase the systemic risk capital buffer to 4.5 per cent, seeking to maintain current capital requirement in practice. This suggests that Norwegian banks may become less competitive as sources of debt financing in future.

The coming year or two will likely see the advent of statutory ESG requirements. The Norwegian Ministry of Finance seems to prioritise implementation of EEA (EU) legal acts in this field, and the FSAN is focused on avoiding adverse effects of ‘greenwashing’ in the financial markets. For private equity fund managers, the increased focus will likely require them to integrate ESG into their investment and risk management processes to a higher degree than what has been the case to date.

Norway has traditionally had a broad and deep economic relationship with the United Kingdom, both before and after the United Kingdom became a member of the EU. Norwegian fund sponsors eager to attract non-Norwegian capital have also often relied on the power of City of London-based placement agents. It remains to be seen how Brexit will affect these relations and investment activity, both in the United Kingdom by funds advised by Norwegian managers and of UK-based funds in Norway.
I OVERVIEW

i Deal activity

Poland is the largest economy in central and eastern Europe (CEE), with a stable banking sector, active capital market organised by the leading stock exchange in the region (the Warsaw Stock Exchange (WSE)) and an established legal framework adjusted to European standards. Poland has consistently maintained growth during the past 25 years, including during the 2007–2009 global financial crisis. A positive macroeconomic environment and a well-developed and cost-effective labour market support the strengthening of Polish businesses, creating many unique opportunities for investors.

In 2018, 71 private equity investments with an aggregate value of €850 million were made into companies domiciled in Poland (compared with, for example, 139 in 2015, 84 in 2016 and 61 in 2017). Although the total number of investments declined slightly in comparison with the numbers from previous years, the total value remains quite steady (with exception to the extraordinary total value in 2017); private equity investors invested €896 million in Polish portfolio companies in 2015, €805 million in 2016 and €2.505 billion in 2017). There were 37 buyouts in 2018 with an aggregate value of nearly €494 million. Poland is the biggest private equity market of the CEE countries, hosting 71 per cent of investments by value in the region.3

In 2018, Poland was again the largest market in the region for exits. A total of 43 divestments were valued in the aggregate at €575 million. By comparison, there were 52 divestments in 2015 (€785 million), 29 in 2016 (€374 million) and 37 in 2017 (€549 million).4 The most common exit route in Poland is sale to another private equity firm.

ii Operation of the market

Management equity incentive programmes

Management equity incentive programmes are commonly used to align investors’ and managers’ interests. Typically, the structures used for such programmes are based either on convertible bonds or subscriptions warrants entitling managers to subscribe for new shares in the company’s share capital upon fulfilment of the conditions described in the incentive

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1 Marcin Olechowski is a partner, Borys D Sawicki is a senior counsel and Jan Pierzgalski is a senior associate at Soltyński Kawecki & Szlezak.
2 2019 figures are not yet available.
4 ibid.
programme. Managers usually benefit from a discount amounting to the difference between the subscription value of the shares and their fair market value. In the case of listed companies, managers are often entitled to subscribe for shares for a pre-determined fixed price. The goals that managers are to achieve depend on the investor’s objective in the investment; typically, goals in private companies include reaching certain earnings before interest, taxes, depreciation and amortisation (EBITDA) or amount of income.

Other incentive programme structures may be based on, for example, share options or phantom shares.

**Sale process**

The sale process in Poland is typical for ‘young’ private equity markets. Half of the potential investment opportunities that are analysed by Polish investment funds are reported by business owners (or their financial advisers) seeking opportunities to sell a business, or to find a new source of financing or a strategic partner. Investment funds actively monitor the market and seek potential investment opportunities (38 per cent of analysed investment projects were found by funds’ investment teams). Active monitoring of the market and the seeking of attractive targets by investing teams play a significant role. The majority of investment opportunities are businesses still led by their original founders (59 per cent in 2014). The second group of investment opportunities are corporates’ non-core businesses (14 per cent) and the third are secondary sales (13 per cent in 2014).

In the case of investing in original owners’ businesses, the sale process often involves prior restructuring of the target. This is because many of the ‘family’ businesses, especially those that were established in the 1990s, continue to be run as private businesses of individuals (primarily owing to tax reasons). A change in the form of running a business and the enterprise’s contribution into the company requires diligent separation of business assets from personal property, and identification of debts connected with the business.

The Polish M&A market is relatively professional, and local sale processes are largely aligned with general European practice. The majority of sellers (although still not more than 70 per cent) are supported by financial advisers, and up to 50 per cent of sales are conducted as competitive auctions. However, negotiations with first-generation owners of small and medium-sized businesses (which are typical in the Polish market) tend to be time-consuming, especially due to the owners’ overestimation of their enterprise’s value.

## II  LEGAL FRAMEWORK

### i  Acquisition of control and minority interests

**Types of companies**

The vast majority of investors’ targets in Poland are companies governed by the Polish Commercial Companies Code (CCC). Thus, the CCC creates the basic legal frameworks regulating control over a target and the rights of a minority investor.

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5  KPMG, Rynek private equity w Polsce 2016.
6  ibid.
7  ibid.
8  ibid.
9  According to a Polish Private Equity and Venture Capital Association (PSIK) representative.
Companies under the CCC are divided into two general classes: partnerships (registered partnerships, professional partnerships, limited partnerships and partnerships limited by shares (SKAs)) and commercial companies (limited liability companies, joint-stock companies and, soon to arrive on the market, simple joint-stock companies). Except for SKAs, partnerships are tax transparent; however, no corporate veil is in place to protect the partners. On the other hand, running a business in the form of a commercial company is connected with double taxation (first to be paid by the company and then by the shareholder) but provides the shareholder with the benefit of the corporate veil. In consequence, a business whose scale may attract private equity investors is usually conducted in the form of a commercial company rather than a partnership (with the significant exception of first-generation ‘family’ businesses).

Another significant factor that influences the preferable form for conducting business are the statutory restrictions on how Polish law-governed investment funds invest. Under the Investment Funds Act (IFA), closed-ended investment funds cannot invest in partnerships, while open-ended investment funds cannot invest in partnerships or limited liability companies. Although these restrictions apply only to Polish investment funds, other private equity investors often also prefer to invest in commercial companies.

**Control in joint-stock companies**

In Polish joint-stock companies, the level of a shareholder’s control over the company is connected with the percentage participation of the shareholder in the total number of voting rights. In a private joint stock company with ‘default’ corporate governance rules derived from the provisions of the CCC, a general assembly (which consists of all of the shareholders) appoints the supervisory board members (while the supervisory board nominates the management board), has the power to dismiss members of the supervisory board and management board, and has the power to adopt critical resolutions for the company. Obtaining basic control over the company requires the acquisition of more than a 50 per cent stake; however, some important resolutions require a higher majority.

Reaching a 50 per cent plus one share shareholding allows the shareholder to appoint the majority of the supervisory board, and indirectly gives the shareholder control over the personal policy of the company. The CCC prohibits shareholders from giving management or supervisory board members binding instructions; however, due to the fact that the general assembly has the power to dismiss the company’s managers, shareholders have, in practice, indirect influence over the policy of the supervisory and management boards.

Although the management board runs the daily operation of a joint-stock company (shareholders are not entitled to act on behalf of the company), undertaking the majority of fundamental corporate actions requires a resolution of the general assembly. A general assembly resolution is required to, inter alia:

- amend the statutes;
- appoint supervisory board members;
- approve financial statements and the management board’s annual reports;
- dispose of, lease or encumber a company’s enterprise or its organised part;

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10 A regulation on simple joint-stock companies was planned to enter into force on 1 March 2020; however, an amendment to the law postponing its entry into force by one year has already been submitted to the Polish Parliament. A simple joint-stock company is essentially a subtype of a Polish joint-stock company, but without share capital, partially influenced by corporate law solutions derived from the common law.
acquire or dispose of real estate (unless the statutes provide otherwise);
issue bonds or subscriptions warrants;
increase share capital and issue new shares;
allocate profits;
exclude a shareholder’s pre-emptive rights (the required majority of votes is four-fifths);
dissolve the company;
merge, demerge or transform the company;
change a private company into a public company; or
change a public company into a private company (the required majority of votes is four-fifths).

The CCC provides for several regulations aimed at protecting minority shareholders. Most notably, shareholders with at least a 10 per cent shareholding may request that an extraordinary general assembly be convened and have influence on the agenda of each general assembly. A 20 per cent threshold of shares in the company allows a minority shareholder (or group of shareholders) to request a vote on the appointment of supervisory board members in groups. In the case of voting in groups, a group of shareholders may vote individually on the appointment of one (or more) supervisory board members, notwithstanding the provisions of the statutes governing the election of the supervisory board members; as a result, minority shareholders who are able to create a voting group may influence the composition of the board. Each shareholder has a right to challenge resolutions of the general assembly, management board or supervisory board. A minority shareholder’s level of influence on the company may be further extended by the statutes of the company, which may, for example, provide for the shareholder’s individual right to appoint a number of supervisory or management board members, or both, or convene a general assembly.

Fiduciary duties and liabilities

The CCC does not expressly state the fiduciary duties of a shareholder towards the commercial company or other shareholders. Shareholders exercise their rights by voting on resolutions at the general assembly. Resolutions may be challenged by other shareholders and members of the management or supervisory boards (or both), which creates a mechanism of control over the majority shareholder’s actions. A resolution may be challenged if it contravenes the statutes of the company or good practices and harms the interests of the company, or if it is aimed at harming a shareholder. The general ‘good practices’ clause allows the majority shareholder’s actions to be opposed in a wide range of circumstances if the company’s or other shareholders’ interests are harmed. Although there are no specific provisions of law governing the matter, legal doctrine and jurisprudence have developed the concept of a duty of loyalty, which shareholders (especially a majority shareholder) owe to the company and other shareholders.

Due to the nature of commercial companies, the liabilities of a shareholder towards a limited liability company or joint-stock company are, generally, limited to the proper fulfilment of an obligation to make a contribution to the company (in exchange for shares). In the case of an acquisition of shares, the acquirer is jointly and severally liable for the contribution with the seller. A shareholder is also responsible towards the company or other shareholders in accordance with the general principles of civil law (i.e., for damages caused by illegal actions).
Company officers (members of the management and supervisory boards, liquidators) are personally liable for the damage caused to the company by their actions or omissions contrary to the law or the statutes, unless they were not at fault. Company officers should perform their duties with higher standards of care connected with the professional nature of their positions; they should act diligently, reasonably, cautiously and with foresight, and anticipating the results of undertaken actions. They are also obliged to act in the best interests of the company (which is independent from the individual interests of shareholders) and treat shareholders equally. Management board members cannot conduct a competing business activity without the company’s consent and are obliged to refrain from performing duties in the case of a conflict of interest. Shareholders, the general assembly and the supervisory board are not entitled to give the management board or its members binding instructions with respect to the management of the company's affairs.

Management board members in limited liability or simple joint-stock companies may become liable for the obligations of the relevant company – jointly and severally with the company – if enforcement proceedings against that company are ineffective and the managers did not timely file for a declaration of bankruptcy (the liability may be avoided if they demonstrate that despite the application not being filed, the debtor has not suffered damages).

Private equity investments (Polish or foreign) in regulated financial institutions are limited to smaller stakes and smaller target institutions by the current policy of the financial services regulator (KNF). This is largely because the suitability criteria applied by the KNF in assessing acquisition of controlling stakes usually include the requirement for investors to commit to a long-term investment horizon, as well as capital and liquidity support that is not compatible with many private equity investors’ policies.

### Regulations applying to foreign investors

Poland, as a Member State of the European Union, forms part of the European Union’s internal market and aims to guarantee, within the framework of applicable regulations, the EU’s ‘four freedoms’ (i.e., the free movement of goods, capital, services and people).

While the obvious beneficiaries of Poland’s membership in the EU are entities from the remaining 27 EU Member States, Poland sets out very few barriers for investors from non-EU countries, as noted below.

The principal remaining limitations on foreign investment are found in the Act on Acquisition of Real Estates by Foreigners (AAREF). Under the AAREF, if a foreigner (i.e., an individual foreign citizen, a legal person with its registered seat outside of Poland or a company domiciled in Poland but controlled by a foreign entity) acquires real property or obtains control over a company holding real property, a prior approval of the Ministry of Internal Affairs is required (under pain of nullity).

The AAREF, subject to some minor exceptions, does not apply to foreigners from the European Economic Area (EEA) or Switzerland, nor does it apply to Polish law-governed investment funds (regardless of the sponsors’ domicile) or to investing in public companies listed on the WSE. Other foreign investors may decide to operate through holding companies incorporated in an EEA country, usually in Luxembourg or Cyprus, to avoid the application and requirements of the AAREF.

The Act on Control over Certain Investments (ACCI) gives the government a tool to control investments (in particular, foreign investments) in companies that are strategic for national interests and security. In general, the regulation follows similar solutions established in other European countries. According to the ACCI, acquisition of a shareholding above
certain thresholds (the lowest threshold is 20 per cent) in companies indicated in secondary regulation issued by the government or acquisition of the company itself requires previous notification to the Minister of State Assets, the Minister of National Defence or the Minister of Marine Economy and Inland Navigation (depending on the relevant company sector), which can oppose the transaction. Lack of notification or acquisition contrary to the opposition results in the invalidity of the transaction and is sanctioned with a fine of up to 10 million zlotys or imprisonment for up to five years. As at the beginning of 2020, only nine entities (leading Polish companies in the energy and telecommunication sector) are subject to ACCI regulations.

iv  Tax matters

Poland conforms to global trends aimed at closing the remaining loopholes in the tax system through various regulations, such as:

a  the General Anti-Abuse Rule (GAAR) and specific tax anti-abuse rules applicable to the exchange of shares and dividends;

b  transfer pricing documentation requirements;

c  the Mandatory Disclosure Rules (MDRs);

d  changing the withholding tax regime by strict application of the beneficial owner concept; and

e  introduction of the exit tax.

Poland has participated in the Organisation for Economic Co-operation and Development’s base erosion and profit shifting project (known as BEPS) and has implemented Council Directive 2014/107/EU (the country began reporting in January 2017).11 Moreover, Poland has signed many double tax treaties (more than 80 conventions) and international agreements on the exchange of information on tax matters.

From an investor’s perspective, the most crucial change was the introduction in 2016 of the GAAR into the Polish tax law system. The GAAR was created as a new tool that tax authorities may apply to reclassify the business operations of a taxpayer who obtains substantial tax profits through tax-avoidance strategies. The clause allows the authorities to ignore artificial legal arrangements, which means that the taxpayer may be obliged to pay the avoided tax with default interest and become exposed to penal fiscal liability. To decide whether a legal arrangement is artificial, various factors should be taken into account, such as excessively complex transactions or the use of conduit entities. To protect taxpayers from the tax authorities’ discretionary powers, the former may apply to the Minister of Finance to issue an opinion that disallows the application of the GAAR. Since 2017, the tax rulings classified as tax abusive do not secure the taxpayer’s position in the case of dispute with authorities. Following the introduction of the GAAR, the tax authorities have conducted numerous tax audits and proceedings targeted at previous optimisation projects (e.g., concerning step-ups on the value of trademarks, commercial premises and financial instruments). The approach of the tax authorities is currently much more aggressive than in the past, and they are even trying to apply GAAR to tax years prior to its adoption. In 2019, the laws concerning GAAR were expanded and tightened.

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The most effective structures for optimisation of business activity carried out in Poland are related to the Polish open-ended investment funds and specialised open-ended investment funds (SFIOs), unless an SFIO applies investment principles and limitations relevant for collective investment funds (CIFs). Comparable EU-based investment funds fulfilling certain conditions will also retain the income-tax exemption.

In turn, structures based on Polish CIFs are not tax-effective. In particular, due to the taxation of CIFs, the structures in which Polish and foreign CIFs participate in fiscally transparent entities have been eliminated from the market. The tax administration classifies such activity as being against the primary purpose of establishing the tax exemption of CIFs (i.e., exemption from taxation of taxpayers’ investment activity conducted through the CIF).

Various tax optimisation solutions regarding contributions of assets to companies, with a portion of the contribution allocated to the share premium, are also now ineffective. Prior to 2017, the taxable revenue from a contribution of assets had been limited to the nominal value of shares received in exchange for an in-kind contribution. However, since 2017, the revenue achieved by the entity making the in-kind contribution is the market value of the contributed assets.

A more detailed description of justified economic reasons warranting preferential taxation of mergers of companies or CIFs and demergers of companies has also been introduced. This ‘small’ anti-abuse rule has also been expanded to the exchange of shares and in-kind contributions of enterprises or their organised parts (and previously, in 2016, to dividends). These activities will no longer be tax neutral if there are no justified economic reasons for them. The tax authorities may challenge the tax neutrality of share exchanges and in-kind contributions of enterprises or their organised parts when these are carried out with the sole purpose of enjoying tax benefits and not for justified economic reasons.

As for transfer pricing documentation, more comprehensive information on related party transactions should be disclosed to the tax authorities. Under these provisions, taxpayers are obliged to prepare more extensive transfer pricing documentation (in particular, local files are expanded). In most cases, benchmarking studies would be necessary. Since 2019, transfer pricing requirements have been limited to transborder transactions. In turn, most transactions among local Polish entities are not currently subject to transfer pricing documentation requirements.

In 2018, the following new anti-abusive rules were implemented:

a new thin-cap regulations limit the amount of tax-deductible interest from intra-group and third-party financing to 30 per cent of EBITDA;

b it is no longer possible to offset interest from loans or credit incurred on purchases of shares against revenues from business activity (debt pushdowns become tax ineffective);

c deductibility of intra-group immaterial services and expenses on intellectual property (IP) rights is limited to 5 per cent of EBITDA;

d the scope of dividends and similar sources of revenues has been expanded, and the application of the exemption based on the Parent-Subsidiary Directive has been narrowed; and

e revenues from commercial premises are now subject to lump-sum tax with no tax costs deductible.

Since 2019, taxpayers and their advisers involved in tax optimisation projects have been obliged to report these projects under the MDRs. The MDRs apply both to individual and corporate taxpayers and require a detailed reporting of the tax-effective activities, transactions
and restructurings. An exit tax was also introduced in 2019, which is charged on the transfer of assets outside Poland and when changing tax residence from Poland to another country. It also applies both to individual and corporate investors. In 2019, the provisions concerning controlled foreign companies were expanded and tightened.

A new withholding tax (WHT) regime has applied to individual taxpayers since mid-2019 and is expected to apply to corporate taxpayers from mid-2020. It provides for some restrictions that impact the application of exemptions and reduced rates to WHT collection. The new regime maintains, in principle, the existing rules for the collection of WHT from payments not exceeding 2 million zlotys with respect to one taxpayer in a fiscal year but obligate the WHT agents to duly examine, in each case, whether tax regulatory conditions for the application of tax exemptions or reduced tax rates are satisfied. These regulatory conditions have been extended since 2019 by, inter alia, strict application of the beneficial owner concept. An obligation to collect the full amount of WHT applies to payments over 2 million zlotys without the possibility of applying tax exemptions or reduced rates unless a taxpayer receives a special opinion issued by the tax authority or if the WHT agent declares under pain of fiscal penal liability that it holds appropriate documents proving grounds for non-collection or reduced collection of WHT. In the case of full collection of WHT, a subsequent refund of tax will be available on condition that the taxpayer proves grounds for application of exemption or reduced rate.

Some positive changes are also observed in the market. The novel IP Box regime was introduced in 2019. Under this regime, revenues related to IP may be taxed at the lower 5 per cent income tax rate. The income tax rate for the smallest corporate taxpayers was also reduced to 9 per cent in 2019.

Poland has commenced its battle to prevent tax avoidance and tax evasion through introducing numerous regulations designed to combat these negative phenomena. It is no exaggeration to state that Poland is becoming a less tax-friendly country, which, in practice, eliminates the possibility of tax optimisation. Additionally, the aggressive approach of the authorities is present not only in income taxes but also in VAT and transfer taxes.

III YEAR IN REVIEW

i Recent deal activity

Although no statistical data for 2019 is yet available, market participants and observers indicate that 2019 has continued to witness the market dynamics observed in previous years. The priority for CEE region investors is to make new investments. In July 2019, 58 per cent of respondents intended to focus on such new investments, while only 32 per cent claimed that they will focus on portfolio management. Investors expected the average size of transactions to remain the same (68 per cent of respondents), while 19 per cent claimed that it will increase. Overall, 55 per cent of investors expected to buy more than they sell.12 Investors also expect that the biggest competition between acquirers will be among market leaders.13 Medium-sized companies remain popular but are seen as less competitive.14

A growing number of Polish public entities engage in fundraising and investing. The first public source of financing on the private equity market was the National Capital Fund (KFK),

12 Deloitte, Central Europe Private Equity Confidence Survey, Summer 2019.
13 ibid.
14 ibid.
a fund of funds sponsored by, inter alia, the government. The KFK manages €230 million of
funds and is focused on small venture capital investments only, providing up to 50 per cent
of their acquisition financing. However, a merger of the KFK with another state-controlled
entity is currently in progress. Another public entity operating on the Polish market is Polski
Fundusz Rozwoju (PFR), established by the Ministry of Treasury with the State Treasury and
Bank Gospodarstwa Krajowego as stockholders. PFR holds the means to approximately 5
billion zlotys. Open pensions funds are restricted from investing on the private equity market.

In 2019, the Capital Investments Fund, which is fully managed by the Prime Minister,
was established. Its main purpose is to acquire shares owned by the State Treasury; however,

it remains inactive as its investing activity is planned to commence in 2021 at the earliest.

ii Financing

The typical structure of financing consists of an investor’s equity, banking loans (senior debt
in the case of other financing) or other sources of financing (e.g., bonds). According to market
surveys, 71 per cent of private equity investors consider that debt financing is easily available
and does not pose an execution risk. A quarter of respondents claimed that debt financing
is difficult to obtain, although promising prospects can be sure to succeed in that area. Only
4 per cent of respondents stated that debt financing is very hard to get and constitutes an
investment barrier. The Polish banking sector is relatively strong, having avoided the global
financial crisis. The level of leverage in Poland (and in the CEE generally) has never reached
the pre-crisis levels achieved in western Europe. In addition, the percentage participation
of equity in capital structures in the CEE (including Poland) in 2014 was reported to be
20 per cent higher than in Europe; the typical loan-to-value ratio for investments in Poland
does not exceed 50 per cent.

Polish investment funds are subject to limitations on incurring debt. Closed-ended
funds may only obtain loans or credit from banks, foreign banks or credit institutions. Other
debt financing available for closed-ended funds is the issuance of bonds, but only with a value
not exceeding 15 per cent of the net value of the fund’s assets. The total value of debt incurred
by closed-ended funds (both in the form of credits and loan facilities and bonds) must not
exceed 75 per cent of the net value of a fund’s assets. Debt financing restrictions are more
stringent in the case of open-ended funds, which may only obtain credits and loans with a
maximum value of up to 10 per cent of a fund’s net assets, with the repayment date being no
longer than one year after acquiring the debt financing, and only from Polish banks or credit
institutions.

In terms of legal documentation, facility agreements are typically based on the Loan
Market Association standard documents with the usual set of clauses. Security documents
are, in turn, local, but there is a well-established practice with regard to both their structuring
and the composition of security packages. Depending on the available assets, the package
usually consists of a share pledge, asset pledge, account receivables pledge or assignment,

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15 KPMG Poland; see footnote 5.
16 PSIK, Time for another look – Central & Eastern Europe Private Equity, 2013.
17 According to the Polish Banking Law, credit institutions are entities whose registered office is outside the
Republic of Poland, but in another Member State of the EU, and that conduct activity in their own names
and for their own account, on the basis of the authorisation of the competent supervisory authorities,
consisting of accepting deposits or other resources entrusted under any redeemable title and consisting of
granting credit or issuing electronic money.
and mortgage. It is often coupled with a corporate guarantee and a voluntary submission to enforcement, which is not a security instrument in the strict sense, but allows for faster satisfaction of the creditor.

iii  Key terms of recent control transactions

Key legal terms of control transactions on the Polish market are rather standard. The most important points are the mechanics of the transaction, conditions precedent, shareholders’ mutual obligations and corporate governance, as well as the sellers’ liability for representations and warranties.

The scope of legal documentation required to effect takeover transactions varies for investments in which the investor acquires 100 per cent of shares, and those in which the investor acquires a controlling stake but the other shareholder (or shareholders) remains in the target company. The latter requires execution of an investment agreement regulating the mutual commitments of the acquiring investor and the shareholder regarding their involvement in the target company and describing its corporate governance structure. Under Polish law, investment agreements are of contractual effect only, meaning that voting contrary to the agreement constitutes a breach of an obligation towards the other shareholders, which may result in liability for damages or an obligation to pay a contractual penalty, but which is valid and has no impact on the effectiveness of the adopted resolution. Thus, the parties will usually strive to specify additional rights of the shareholders directly in the company’s statutes because a resolution adopted in breach of the statutes may be effectively challenged before a court. Commonly, such additional rights of the shareholders will include the right to appoint some of the management or supervisory boards members (or both) to monitor the company’s regular business activity; and the establishment of a blocking minority to protect the shareholders from a loss of investment value (e.g., in the case of the adoption of resolutions approving the disposal of key assets) and from the dilution of their corporate rights. On the other hand, the controlling investor will usually aim to structure the statutes in such a way that the company officers appointed by it may freely conduct the company’s day-to-day business, and to have the majority required to adopt most of the resolutions to avoid deadlocks. Investment agreements will also typically provide for regulations facilitating an exit from the investment, such as tag-along and drag-along mechanisms, rights of first refusal and provisions facilitating a possible initial public offering in the future (e.g., regarding the obligation to adjust the statutes accordingly).

Other key terms of a share purchase agreement include representations and warranties, which are usually extensively negotiated between the parties as the scope of liability of the seller depends primarily on the wording of the contract in this regard, as well as conditions precedent, which determine the mechanics and timing of the closing of the transaction. Typical conditions precedent include subscription for shares in the increased share capital, registration of amendments to the statutes with the commercial registry and obtaining concentration approval from the antitrust authority.

Liability caps range on average between 15 and 25 per cent of the purchase price (with, however, 100 per cent of the purchase price as the cap for liability on title). Representations and warranties insurance is increasingly considered as a possibility; however, it is still not much used in practice.

In 2016, the new legislation on agricultural lands entered into force and, unexpectedly, had an impact on transaction mechanics. The Polish Public Agricultural Lands Agency has a priority right in the case of any sale of agricultural land. To prevent circumvention of this right,
the new regulations also provide the Agency’s priority right with respect to shares in a company that holds any agricultural land. The size of such given company, the structure of its assets and the value or area of the given agricultural land are irrelevant for the application of the priority right. On the other hand, there is no register of agricultural lands in Poland, and in certain cases it is not clear whether such land is in fact agricultural. As a result, in the case of any share deal, due diligence of a company’s real estate is required and, if the company holds agricultural land, non-performance of a priority right by the Agency is a condition precedent.

iv Exits
In the opinion of private equity investors, the most likely type of exit from an investment is a trade sale to a European strategic investor outside the CEE.18 One-fifth of investors believe that a strategic acquirer will be from Poland, and 17 per cent that it will be from the CEE. No investors have claimed that an acquirer will be from outside Europe. The second most likely exit route is via the public market. However, it should be compared with hard data, according to which the most common exit route in 2018 was sale to another private equity firm.19

IV REGULATORY DEVELOPMENTS

i Investment funds
Polish investment funds operate in accordance with the IFA. There are three basic types of investment funds: open-ended, specialised open-ended and closed-ended. Each investment fund type must be managed by an investment fund management company (TFI). Both investment funds and TFIs are subject to the supervision of the KNF. Establishment of a TFI or an investment fund requires a licence from the KNF. The IFA provides for a number of limitations as regards types of investments that an investment fund may carry out, as well as requirements as to the diversification of risk. If a TFI or an investment fund managed by a TFI breach a provision of law, and especially of the IFA, or infringe a fund’s statutes or the terms and conditions of a licence (e.g., if the investment fund invests contrary to the IFA or its statutes), the KNF may impose a financial penalty of up to 500,000 zlotys on the TFI or cancel the licence.20

Alternative investment companies (ASIs) are an additional category of investment vehicle and are deemed alternative investment funds under the AIFMD. ASIs are generally non-regulated investment vehicles in the form of ‘ordinary’ commercial companies that are governed by the applicable rules of the CCC.

ii Antitrust issues
Larger-scale transactions that may influence the market come under the purview of both the Polish and European competition authorities (the President of the Office of Competition and Consumer Protection (UOKiK) and the European Commission, respectively). Any M&A transaction subject to statutory turnover thresholds may require competition clearance. If the turnover thresholds are exceeded, Polish antitrust law requires prior notification to the UOKiK on the intention of concentration. Until the UOKiK issues a decision allowing the transaction

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18 See footnote 5.
19 See footnote 3.
20 In 2019, several TFI licences were revoked as a result of the widely discussed GetBack case.
(or the lapse of the statutory deadlines for the UOKiK to issue the clearance, which are one or four months, depending on the complexity of the transaction), the acquirer should refrain from closing the deal. Antitrust issues are especially relevant in the case of a trade sale exit.

V OUTLOOK

We believe that, overall, the Polish private equity market has significant potential for further growth.

Poland is typically the largest CEE private equity market and still hosts the highest number of companies invested. In 2018, the value of private equity investments in Poland amounted to 0.171 per cent of the country's GDP, which is slightly higher than the CEE average of 0.17 per cent.21 These two factors, when combined, suggest that the already large market should continue to expand. A high average rate of return on investment adds to the positive picture of Poland as the place to invest.22 The general impression of market participants and observers is that private equity investors are taking an increasingly large portion of Poland's M&A market. As a result of investments in recent years and the continued interest of private equity investors in Poland, sales between private equity funds are increasingly common.

21 See footnote 3.
22 See footnote 5.
Chapter 14

PORTUGAL

Mariana Norton dos Reis and Miguel Lencastre Monteiro

I OVERVIEW

i Deal activity

According to the 2018 European Private Equity Activity Report, approximately €80.6 billion of equity was invested in European companies in 2018, with €58.8 billion relating to buyout investment. Growth investment, which is typically a minority investment in mature companies that are seeking primary capital to expand and improve operations or enter new markets to accelerate the growth of business, reached amounts close to €11.9 billion, meaning that seed, start-up and later-stage financing (venture capital) make up a fraction of the total private equity investment made in the European market. In terms of geographical investment flows, the largest part of capital circulated inside the European territory, with €51.2 billion capital investment made domestically within European countries and €25 billion made in cross-border investments within Europe. The most targeted sectors were business products and services, ICT (communications, computing and electronics) and consumer goods and services, with a combined share of approximately 62.5 per cent of all private equity investment made in Europe.

This conjuncture was reflected in Portugal, whose economic growth, albeit with some deceleration, affected its private equity market while maintaining similar distributions of investment by stage and sector. Following the growth trend of previous years, assets under management (sum of equity, financing, liquidity, options on derivatives and other private equity assets) reached €4.8 billion by the end of 2018, with an increase of €42.9 million in comparison with the previous year. This positive development was due to an increase in the number of equity funds operating in the Portuguese private equity sector (from 95 to 117). Notwithstanding, the investment amount (i.e., the sum of equity and other investments) decreased 2.9 per cent in 2018. Equity only accounted for 33.2 per cent of the total amount invested in the national private equity sector, while other investments appear as the major target in 2018, amounting to up to 66.8 per cent (€2.3 billion). Of these other investments, accessory contributions, shareholder loans and other loans take on the largest role. In comparison with the previous year, investments in other assets (derivative positions and other assets) and equity increased by, respectively, 6.1 per cent and 21 per cent, mainly due to investments in domestic targets. The value of other investments decreased (6.3 per cent) but

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Portugal

only for domestic companies (6.4 per cent). In fact, the amount invested in non-domestic other investment targets increased significantly (115.3 per cent), although this represents a very small percentage of total investments. Furthermore, investments through deposits and cash decreased by 3.8 per cent (to €17.7 million).

Currently, there are 50 private equity companies and 134 private equity funds operating in the Portuguese private equity sector. By the end of 2018, investments of these private equity funds were spread out over 554 targets and investment units in 18 private equity funds, totalling €4.6 billion. Investments of private equity companies are spread out over 63 private equity companies and investment units in 42 private equity funds, totalling €237.5 million. This shows that investment via private equity funds, comprising 95.1 per cent of the total investment in private equity assets in Portugal, is staggeringly more significant than via direct investment through private equity companies.

There is a significant concentration of the Portuguese market, with nine private equity funds representing around 58.9 per cent of total assets under management, with management being carried out by six operators, three of which manage 57.8 per cent of the global fund value. This concentration is also apparent from the fact that eight out of a total of 1,259 equity participations represent approximately 34 per cent of all assets under management registered in Portugal, and the 46 participations with a minimum value of €5 million represent 61.3 per cent of the total managed participations. There is only one equity participation exceeding €100 million.

As for the targets that private equity agents generally envisage, holding companies that manage non-financial corporations acting as vehicles for investments in other companies are quite popular, as they allow end investments not to be disclosed. Excluding such holding companies, the activities that captured the largest amounts of private equity investment in 2018 were the real estate and process industry sectors, which jointly represent 20.4 per cent of the total investment in private equity in Portugal. ICT and hospitality and food service activities also represent an important private equity investment stake in Portugal, following the growth trend verified in the sectors closely linked to tourism.

In respect of the stages of investment, private equity comprises 82.5 per cent of the total investment, with the largest branch of this stage of investment being the turnaround (which represented 33.5 per cent of the total, but with a slight decrease (0.3 per cent) in comparison with 2017) followed by the expansion stage (22.4 per cent). The growth of both the expansion and the replacement capital stages rose from an aggregate proportion of 25.9 per cent to 28.2 per cent. Venture capital evidenced a downturn in the number of participations (from 771 to 754) and the amount of investment captured. At this point, and contrary to the expectations occasioned by the multiple measures implemented by the Portuguese state, the start-up stage holds at 8.4 per cent of the total amount invested, as against 9 per cent in 2017.

Private equity investments differ in terms of management approaches between hands-on (technical supervision and management involvement) and hands-off (restricted to the allocation of funds). This distinction is also related to the level of control that the investor intends to exercise. By the end of 2018, 64.9 per cent of all investments concerned shareholdings under 30 per cent of the total share capital of the targets.

Concerning the duration of investments, nearly 28.5 per cent of private equity investment had a term of less than four years and 9.6 per cent were kept for more than 10 years.

ii Operation of the market

Management incentive arrangements

Management incentives may be structured as compensation schemes linked to predetermined performance thresholds, equity-linked participation programmes, granting managers the option to acquire shares at a discount or vesting mechanisms where shares are gradually ‘unlocked’ and offered to managers at a discount. Furthermore, exit bonuses are standard market practice for almost any private equity entity in Portugal. From a strategic point of view, equity incentives are a reliable source of interest alignment between the management and the company, constricting both parties to equal goals and targets.

Since management incentive arrangements are designed to intersect interests of both the management and the investors, general prohibitions (or severe restrictions) on the transferability of equity or the incentive itself are used to ensure that it is exclusively held for the benefit of management. This kind of mechanism is complemented by the fact that, in the event of change of management, the interest may be transferred back to the company or to the majority shareholder. For this purpose, ‘good-leaver’ and ‘bad-leaver’ provisions are used to adjust the vested equity accordingly.

Ratchet arrangements are mechanisms designed to align the amount of equity held by owner managers with the performance of the company after the initial investment. However, ratchet arrangements are not regulated under Portuguese law, and the question of whether the gains obtained from such arrangements are taxed as labour remuneration (and consequently subject to personal income tax and social security) or as capital gains is currently still under discussion and may vary according to the particular structure implemented.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Portuguese law sets no restrictions – neither legal nor regulatory in nature – on the ownership of companies and assets by foreign entities or individuals. However, a framework for the acquisition of control over strategic assets was created by Decree-Law No. 138/2014 of 15 September 2014, aiming to ensure national defence and safety, as well as the guarantee the country’s supply of national-interest structural services such as energy, transport and communications. Takeovers of assets in any of these areas, which are deemed to be strategic, by nationals of a non-European Economic Area country, either an individual or legal entity, may require a prior assessment by the cabinet member overseeing the relevant sector. Should the government ultimately determine that the acquisition might harm national interest by threatening either the country’s security or its provision of fundamental services, the transaction might be prevented from occurring.

Portuguese law sets some rules on group companies, which are relevant for the acquisition of minority and control interests. Indeed, according to the provisions of the Portuguese Companies Code, whenever a simple interest relationship is established (i.e., a company holds an interest equal to or greater than 10 per cent in another company), the acquirer company must notify the acquired company, in writing, of all acquisitions and divestments in the latter’s equity.

In the case of a company that establishes a relationship of control in another company, which is presumed after the acquisition of a majority stake, if the acquirer has more than half
of the voting rights or if it has the possibility of appointing more than half of the members of the board of directors or of the supervisory board, the dependent company may not purchase shares of the former company.

Pursuant to the Portuguese Companies Code, if a company acquires 100 per cent of the share capital of another company, a general shareholders’ meeting must be convened by the board of directors of the dominant company within six months, to decide whether to dissolve the dependent company, transfer the shares of the dependent company or maintain the existing situation.

Portuguese law also contains squeeze-out and sell-out rules applicable as follows: if a company acquires, directly or indirectly (by means of a company in the same group, or through a dependent company) an interest greater than 90 per cent in another company, the acquiring company must notify the latter of this fact within 30 days of the moment that this amount of interest was achieved. A squeeze-out mechanism is available within six months of the notification, whereby the dominant company may secure the remaining equity from the other shareholders. Similarly, if the dominant company does not squeeze out the remaining shareholders, any minority shareholder may, at any time, demand in writing that the majority shareholder purchases the remaining shares from it, within a time limit of not less than 30 days. In the absence of said purchase, or if being considered unsatisfactory, the minority shareholder may request a judicial purchase from a court of law.

Particularly relevant to private equity investors that do not acquire large interests in their targets, the Portuguese Company Codes ensures, through multiple provisions, that minority shareholders are protected from certain abuses.

First, in public limited liability companies (SAs), although the general shareholders’ meeting must be convened according to the law or when any of the boards (board of directors, audit commission, executive management council, audit committee, general and supervisory council) deems it necessary, it will also be convened when one or more shareholders with an interest exceeding 5 per cent requires it. As for private limited liability companies (Ldas), all shareholders may request the managers to convene a general shareholders’ meeting or include items in the agenda, and no shareholder may be restricted from participating in the general shareholders’ meeting, even if it is prevented from exercising its voting rights.

For a public or private limited liability company to decide on matters such as changes to the company’s by-laws, mergers, demergers, transformations or dissolution, a qualified majority is required.

Regarding information rights, public and private limited liability companies operate under different frameworks. Any shareholder of a public limited liability company that holds an interest equal to or greater than 1 per cent of the share capital may, on the basis of justified grounds, consult management reports, accounts, supervisory boards and certified public accountants’ reports for the previous three years; convening notices, minutes and attendance lists of the general or special shareholders’ meetings or bondholders’ meetings for the previous three years; the global remuneration amounts paid to members of the company bodies for the previous three years; the global remuneration amounts paid to the highest-paid employees; and share registry documents. In private limited liability companies, managers must provide true, complete and clear information on the company’s management and ensure that inspection of books and documents can be made by any shareholder that so requests it. Although this information right may be further developed in the company’s by-laws, its effective exercise may not be prevented or unjustifiably limited in the by-laws.
To prevent abuses by majority shareholders, resolutions approving the non-distribution of profit with the intent to pressure minority shareholders into relinquishing their shares; the increase of share capital with the intention of rendering minority shareholders unable to partake in such an increase; or the change of company headquarters may be annulled if the court finds that the resolution was intended to harm the interests of the company or some of its shareholders.

On the other hand, like majority shareholders, minority shareholders are also subject to the provisions of the Portuguese Companies Code, which may prevent improper conduct such as the abuse of judicial opposition to corporate resolutions with the intent of forcing the company to carry out a transaction that specifically benefits the objector, or even the withholding of votes in favour of a proposed change of the by-laws that is essential to preserving the corporate interests, when those votes are essential for the approval of the relevant resolution.

ii Fiduciary duties and liabilities

Pursuant to the Portuguese Companies Code, directors are subject to fiduciary duties, namely the general duties of care and of loyalty. The duty of care is defined as the standard of a diligent and responsible business person and requires directors to have the availability and willingness to carry out the company’s management, the proper technical capacity and skills for the performance of the relevant functions and an understanding of the company’s business, appropriate for the due performance of the role.

Directors are also bound by a duty of loyalty according to which they must exclusively act in the best interests of the company and of the stakeholders who are relevant for its sustainability, in particular employees, customers and creditors. In addition, the duty of loyalty also comprises three fundamental principles, namely: (1) a non-competition obligation towards the company; (2) a prohibition on taking advantage of corporate opportunities; and (3) a prohibition on trading with the company, except in specific, legally established, situations.

Furthermore, rules set out in the Portuguese Company’s Code establish that directors must avoid any activity that can result in a conflict of interest with the company unless express consent has been granted by the general meeting of the shareholders and may not vote on resolutions of the board of directors if they are conflicted in any way (for example, if they are involved in a management buyout). Directors may only enter into agreements with the company in the situations strictly set out in law, may never use the company’s assets for their own benefit or the unlawful benefit of third parties and are bound by a duty of confidentiality in respect of information related to the company that is not available to the public.

The duties directors are bound to may be further expanded by means of management agreements and in the by-laws of the company.

Managing entities of private equity funds are subject to specific provisions, established in Law No. 18/2015.5 The managing entity, in the exercise of its functions, acts on behalf of the investors, independently and in their exclusive interest, with the obligation to perform

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all acts necessary for a diligent and responsible administration of the private equity fund, according to high levels of integrity, diligence and professional ability. In the performance of its duties, a managing entity shall safeguard the legitimate interests of the investors, refrain from entering into arrangements that may lead to a conflict of interests with investors and set up an organisational structure and internal procedures proportional to the size and complexity of their activity. Apart from being bound to the duties of care and loyalty set out above, directors of managing entities must satisfy demanding fit-and-proper criteria established by the Portuguese Securities Market Commission (CMVM).

In accordance with general principles governing civil liability, any director that wilfully or negligently infringes another person’s right, or a legal provision designed to protect the interests of others, is obliged to indemnify the aggrieved party for the damage arising from the infringement. Damage caused to the company, shareholders or third parties may arise from an action or omission in breach of the legal or contractual duties of a director. In respect of damage caused to the company, Portuguese law lays down a rule of fault-based liability, albeit with a presumption of guilt, rather than one of strict liability. Therefore, directors are liable for the damage caused to the company, unless they prove that they did not act with fault. Directors are also liable for damage directly caused to shareholders and third parties to the extent that the aggrieved parties provide evidence of unlawful or negligent conduct on the part of the relevant director that resulted in the damage; furthermore, the director’s liability is joint and several with the other directors. Furthermore, directors can be held responsible for damage to creditors of the company, and the applicable rules in this case do not differ significantly from those regarding damage caused to shareholders and third parties, with the single difference that the aggrieved party bears the burden of proving that the non-payment of the claims is due to the insufficiency of assets of the company and that the insufficiency arises from the director’s fault and the breach of the legal provisions designed to protect creditors of the company. The insufficiency of assets alone is not enough to establish the directors’ liability.

One or more shareholders holding a minimum share quota of 5 per cent of the company (2 per cent in listed companies) may, in the name and on behalf of the company, file a lawsuit against a director with the intention of receiving compensation for the damage suffered, without prejudice to other lawsuits for compensation in respect of individual damage caused to that same shareholder.

III YEAR IN REVIEW

i Recent deal activity

Even though the amount of assets under management registered an increase of €42.9 million in comparison with 2017, reaching a total of €4.8 billion by the end of 2018, the value of local private equity investment suffered a decrease of 2.9 per cent in 2018, mainly because of a decrease of €103 million in investments made by private equity funds. This dichotomy between the number and the value of deals made shows that the Portuguese market is quite irregular.

In spite of this, various deals were recently completed by private equity funds or companies.
An investment fund managed by UBS acquired from the Spanish investment fund Artá Capital, SA for a price of €100 million, the Portuguese gas company Gascan-Gases Combustíveis, SA, which distributes around 13,000 tonnes of propane gas per year to more than 700,000 clients.

Sonae Investment Management, AITEC and BPI reached a deal to sell 100 per cent of Saphety Level – Trusted Services, SA to its management team. Saphety’s group is divided into three companies that provide communication services, including training and consulting, electronic data processing and certification, marketing, development and electronic software invoicing. The management buyout was supported by Oxy Capital.

An investment fund managed by Atena Equity Partners – SCR, SA acquired Malo Clinic, a health company with a turnover of €30 million and more than 500 employees.

In the insurance sector, Apollo Global Management sold its wholly owned subsidiaries Company Seguradoras Unidas and AdvanceCare to Group Assicarazioni Generali SpA for a total amount of €600 million. The Seguradoras Unidas Group (which owns Tranquilidade, Açoreana and Logo) generated a total value of €800 million in insurance premiums and a profit of €50 million in 2018.

At the end of 2019, in the telecoms sector, MEO (Altice Europe’s Portuguese subsidiary) sold almost half of the fibre optic network in Portugal to Morgan Stanley Infrastructure Partners. The transaction was implemented through the spin-off of the fibre optic network into a wholesale vehicle and subsequent transfer of 49.99 per cent of such vehicle to the purchaser. The transaction was based on an enterprise value of €4.63 billion, with €1.565 billion being paid in 2020 and, subject to performance, €375 million in December 2021 and €375 million in December 2026.

In 2020, the Portuguese state has announced that the Development Finance Institution and the European Investment Fund (EIF) have committed €100 million into Portugal Growth Capital Initiative II (PGCi II), the largest private equity and growth capital programme in Portugal, which aims to mobilise more than €500 million to finance small and medium-sized companies. PGCi II will involve an investment period of four years, during which time EIF will select six to seven growth capital and private equity funds managed from Portugal.

### ii Financing

Private equity transactions are generally carried out with resort to the equity raised by the private equity entity, but also with support in external financing.

Debt financing structures include senior term facilities, senior revolving facilities and mezzanine facilities, which usually require security packages, including pledges over shares, receivables and credit rights under the transaction documents, subject to financial assistance rules.

An important restriction that private equity entities face when resorting to leveraged acquisitions is the prohibition against financial assistance (financing or securing the acquisition of a public limited liability company’s own shares). However, there are mechanisms to mitigate the effects of this prohibition, namely the granting of pledges over the target’s shares by its shareholders or the tranching of facility agreements to segregate amounts that may be secured by the target company (for example, in respect of working capital requirements) from those that may not (namely, those raised for the acquisition of the target’s shares) and resorting to distributions of free reserves or reduction of share capital.
iii  Key terms of recent control transactions

Private equity transactions each have their own characteristics, their terms depending on a number of factors, including, but not limited to, the quality and quantity of information disclosed by the seller, the timeline of the transaction taking place and whether due diligence is carried out beforehand.

To mitigate risk, a contractual framework of representations and warranties is usually negotiated between the buyer and seller (more or less robust depending on the profile of the parties, the assurance provided during the due diligence process and the negotiation phase of the transaction) that, if breached, may lead to a number of consequences, typically an indemnity in respect of a claim for damages subject to de minimis, thresholds and caps. Contingencies identified in the due diligence process are either addressed as a price reduction or a specific indemnity. In private equity deals, parties tend to resort to warranty and indemnity insurance (generally purchaser insurance) to cover the purchaser against a breach of the representations and warranties, subject to certain limitations, excluding the contingencies known by the purchaser (revealed in the disclosed information) and certain uninsurable matters.

Risk can also be mitigated by means of purchase price structure or adjustment clauses. The most common mechanisms for structuring the purchase price are the locked-box mechanism and a purchase price adjustment based on completion accounts, which are essentially distinguished by the date of transfer of economic risk. With the locked-box system, the valuation of an invested company is based on a historical set of reference accounts (the locked-box accounts), usually dated before the closing of the transaction. This mechanism is very much used in private equity deals and particularly favourable to the seller since there will be no subsequent purchase price adjustment and it results in a swifter, simpler and more cost-friendly deal, since both parties will know the amounts each party has to receive or concede at a specific moment of the transaction. The locked-box system may have variables, namely by setting an interest in favour of the seller to compensate it for the earnings until closing. Recent deals bring more complexity to the locked-box system with ‘hybrid’ solutions as to the cash produced or date of valuation of the company. Under the completion accounts clause, the definition of the final price is deferred until the moment of the closing of the transaction, with the investor disbursing the purchase price in accordance with the real level of assets and liabilities of the target at closing. The parameters according to which the adjustments of the final value of the purchase price are calculated are usually contractually established in the share sale and purchase agreement.

Conditions precedent are also frequent and standard market practice in almost any private equity transaction, their terms and scope depending on, among other factors, the sector and industry of the target and the need to obtain any regulatory authorisations or third-party waivers or approvals.

As a general standard, the fulfilment of conditions precedent may include both best effort and cooperative obligations. The former determines the amount of effort expected and required of the buyer to satisfy the conditions precedent. The level typically agreed regarding the accomplishment of conditions precedent related to merger control or regulatory authorisations is that of ‘commercially reasonable efforts’. On the other hand, cooperative obligations set both parties’ mutual duties to cooperate in the attainment of the conditions precedent (e.g., reciprocally providing sensitive information and reviewing filings to regulatory authorities). ‘Hell-or-high-water’ clauses, imposing upon buyers the
obligation to do all that is necessary (as required by the relevant regulatory authorities) to satisfy the conditions precedent, are not common, because of their potential to harm the buyer or the target.

Considering the difficulties in ensuring the investor’s willingness to obtain financing for the transaction between the signing and closing, there is usually some reluctance on the part of the seller to include related conditions precedent. Should a special purpose company be incorporated by the buyer to acquire the target shares upon the closing, it is common for the seller to ask for an equity commitment letter to be provided. This letter is only to be effective when the transaction’s conditions precedent, as set out in the sale and purchase agreement, are fulfilled.

While the legal system in place in Portugal is grounded in civil law, the importance of major common law jurisdictions such as the United Kingdom and the United States in international business has significantly shaped the framework for cross-border deals. Even though Portuguese law governs the overwhelming bulk of transactions involving Portuguese companies, it is within the parties’ powers to freely choose a different governing law for the transaction documents. This is more common when one of the parties is a foreign investor. Accordingly, as long as Portuguese law’s mandatory rules (such as governing provisions on the transfer of shares, assignment of credits and obligation, among others) are abided by, parties to contracts of either a civil or commercial nature have the right to determine the governing law as provided for in the Rome I Regulation,6 which is in force in Portugal.

iv Exits
In 2018, divestments were in large part made through third-party sales, which amounted to 67.8 per cent of the total divestment in private equity assets and are mainly concentrated in companies in the expansion stage.

Following the trend of previous years, no divestments were made through an initial public offering.

IV REGULATORY DEVELOPMENTS

Pursuant to the Portuguese Securities Code and Law No. 18/2015 (the Legal Framework for Private Equity), prudential and market conduct supervision of private equity entities in Portugal is carried out by the CMVM.7 As regulator, the CMVM has legislative competencies and sets out the rules on, but not limited to, asset and debt valuation, accounting organisation, duties of information and fit-and-proper requirements of the members of the corporate bodies and holders of qualified shareholdings of and in private equity entities.8

With the introduction of the Legal Framework for Private Equity, private equity entities may be subject to one of two legal regimes, depending on the value of their assets under management. If the asset value under management of a private equity entity is greater than €100 million (in respect of portfolios containing assets acquired with recourse to leverage) or €500 million (in respect of portfolios not containing assets acquired with recourse to leverage

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7 Regarding the supervision of managing entities of private equity investment undertakings, the CMVM may cooperate with the Portuguese Central Bank and the European Securities Market Authority.
and in respect of which there are no redemption rights for an initial five-year period), private equity entities are considered to be above a relevant, legally established threshold, and are subject to a more demanding legal framework than entities that do not have assets under management that cross any of these two thresholds. Private equity entities that fall under the more demanding framework are subject to, among other things, the following rights and obligations:

- the prior authorisation of the regulator for their incorporation;
- the EU passporting system for banks and financial services applicable to the private equity fund participation units concerned;
- disclosure to the regulator of outsourcing of management and other services; and
- a requirement for the implementation and maintenance of conflict-of-interest policies to avoid, identify and manage potential conflicts.

In 2018, Decree-Law No. 56/2018 of 9 July 2018 amended the Legal Framework for Private Equity. Among other changes, the Decree-Law removed the 10-year time limit on the qualification of private equity investments, allowing private equity companies and funds to manage their portfolio in a more flexible way; introduced further clarification of the calculation methodology to be followed to determine the legal framework applicable to private equity entities; and extended the scope of private equity investments aimed at promoting social entrepreneurship to include entities other than companies, such as associations and foundations.

In 2019, Decree-Law No. 144/2019 of 23 September 2019 also amended the Legal Framework for Private Equity, which provides for the transfer to the CMVM of the powers and competences relating to the prudential supervision of investment fund management companies and securitisation fund management companies, which was previously carried out by the Bank of Portugal. This legal act incorporated credit funds (loan funds) in the Portuguese legal system and qualified them as specialised alternative investment schemes of credit, with a view to fostering the capital market and diversifying companies’ sources of funding, providing financing. These funds are committed to financing the economy directly through the granting of credit to companies and indirectly through the acquisition of credits, including non-performing loans held by banks. Notwithstanding, these funds are not allowed to carry out certain operations, such as short sales of securities; securities financing transactions, including securities lending; or derivatives, except for the purpose of risk coverage. Additionally, these funds are not allowed to lend money to natural persons or financial institutions.

The CMVM recently submitted for public consultation a proposal amending CMVM Regulation No. 3/2015 to set up the legal framework applicable to loan funds, as provided for in Decree-Law No. 144/2019. The public hearing ended on 10 January 2020, but there is no information on the enactment of the legal framework.

The CMVM has also recently submitted for public consultation a regulation defining the form and content of the transparency obligations of collective investment scheme management companies and credit securitisation fund management companies, to inform the CMVM on a quarterly basis of their economic and financial situation. The public hearing ended on 17 December 2019, but the regulation has not yet been enacted.

9 Public Consultation No. 7/2019.
V OUTLOOK

Following the developments of private equity investment registered in Europe, the total amount of assets under management in the private equity sector maintained the growth trend of previous years.

However, although turnaround transactions still represented the majority of private equity deals in Portugal in 2018, there has been a continued decrease in this type of transaction, replaced by a trend for growth investment and management buyouts. This rebalancing of private equity, undertaken by more speculative participants through more conservative transactions, indicates that the market has matured and traditional investors are becoming more confident in the domestic business fabric.

Other factors, such as new private equity firms becoming active in the domestic market, increased appetite of global private equity firms in the Iberian and Portuguese markets, political and regulatory stability, low interest rates, an increase in financial fund willingness to invest in certain transactions, and several positive macroeconomic forecasts, all augur well for the development of the private equity sector in Portugal in the coming years.
I OVERVIEW

i Deal activity

Despite a 5 per cent dip in deal count in 2019, M&A activity in Singapore continued to thrive with a total deal value for the year of US$35.3 billion, according to a report released by deal intelligence service Mergermarket. This marked a 125.6 per cent increase in deal value from 2018. Corporate finance adviser Duff & Phelps notes that outbound deals continued to lead the overall charge, with 291 outbound deals contributing to approximately two-thirds of Singapore's total M&A deal value between December 2018 and November 2019. Real estate emerged the dominant sector in 2019, overtaking the banking, financial services and insurance sectors. This was driven by significant privatisation and three mega-mergers of real estate investment trusts led by OUE Limited, CapitaLand Limited and Frasers Property Limited, respectively. Technology was the next most active sector, followed by industrials.

Private equity (PE) and venture capital (VC) investments in Singapore remained robust in 2019 as well, with a record high volume of 166 PE/VC investments (amounting to US$6.5 billion), an increase from the 154 deals in 2018. While the total PE/VC deal value in Singapore edged slightly lower than that for 2018 (US$6.6 billion), Duff & Phelps notes that it continued to be greater than that of Indonesia and Malaysia for the same period. Research outfit Prequin also reported that Singapore has maintained its status as the regional hub for VC deals, generating US$2.4 billion out of the US$3.4 billion in total VC deal value in Association of South East Asian Nations markets as at June 2019. As a whole, South East Asia's PE/VC markets have remained upbeat despite global economic volatility, owing largely to the growth in the technology sector in the region over the years.
Some of the larger deals in the VC space were YY Inc’s US$1.5 billion acquisition of Singapore-based Bigo Technology Pte Ltd and Softbank Vision Fund’s US$1.46 billion investment in Singapore-based Grab Holdings Inc. Sovereign wealth funds continue to be the key drivers behind M&A activity in 2019, with notable examples including the acquisition by GIC Private Limited (GIC), with consortium members, of Ultimate Software Group Inc for US$11 billion and Genesee & Wyoming Inc for US$8.4 billion. In October 2019, Singapore investment firm Temasek Holdings announced a S$4.08 billion pre-conditional partial offer for Singapore-based diversified group Keppel Corporation, to gain a controlling stake in the conglomerate. On the PE front, the privatisation of 800 Super Holdings Limited, a Singapore-listed environmental solutions provider, was funded by KKR through a hybrid combination of debt and structured equity financing, and EQT Mid Market Asia invested in Health Management International Ltd, a reputable private healthcare provider with a regional presence in Singapore, Malaysia and Indonesia.

In terms of exits, Temasek Holdings sold the Ascendas-Singbridge group of companies to Singapore-listed real estate giant CapitaLand Limited for US$8.1 billion, which resulted in the creation of the largest diversified real estate group in Asia. Another significant real estate deal was the sale by M+S Pte Ltd, which is 60 per cent owned by Malaysian sovereign wealth fund Khazanah Nasional and 40 per cent held by Temasek Holdings, of DUO Tower and DUO Galleria, a premium grade-A office asset with ancillary retail in Singapore, to Allianz Real Estate and Hong Kong private equity firm Gaw Capital Partners.

**ii Operation of the market**

Due to the continued volatility in the capital markets, more PE exits are carried out through trade sales, redemptions and secondary sales, rather than the traditional public flotation of target company shares.

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A trade sale process by way of a controlled auction has the advantage of creating competition among bidders, thereby encouraging higher prices and more favourable terms for the vendors. The controlled auction process also provides a greater degree of confidentiality and allows for greater control of the data room.

Depending on the management of the process and complexity of the sale assets, a controlled auction process in Singapore may take anywhere from five months to a year to complete. While the specific mechanics may differ in each case, a standard sale by way of controlled auction would generally involve a few stages.

The process usually commences with the circulation of a teaser or fact sheet about the sale assets to potential bidders. Sufficient information has to be provided (i.e., business model, strategy for growth, principal assets and limited financial information) to generate interest and elicit meaningful bids. Upon execution of non-disclosure agreements, potential bidders that have expressed interest will be provided with an information memorandum and process letter setting out the bid process rules, timeline and parameters for indicative proposals. Bidders that are shortlisted to progress to the next phase of the sale process will be allowed access to the data room (although there may still be black box items, in some cases depending on whether the bidder is a strategic bidder or another financial sponsor); scheduled management presentations and interviews with the management; and participation in site visits. When dealing with bidders that are competitors of the target company, precautions should be taken to prevent the sharing of commercially sensitive information and, where necessary, such bidders may have to establish a ‘clean team’ to undertake the due diligence.

The bidders will be required to submit a final proposal and proposed markups on the definitive agreements by the end of this phase. In selecting the final bidders for final negotiations on the definitive agreements, the PE sponsor will weigh the bid price offered against the terms each bidder is seeking (especially with regard to retention sums, warranties and indemnities). The use of warranty and indemnity insurance to mitigate deal risk for PE firms is widely accepted now. The auction process concludes with the selection of the winning bidder and the execution of the definitive agreements.

One important factor that drives a successful exit for a PE sponsor is the ability to effectively retain the management of the portfolio company that it invests in, and to align the interests of the management with its financial objectives. Therefore, it is fairly common for a PE sponsor undertaking a Singapore going-private transaction to offer incentive plans to the management of the target company to ensure that they are retained and incentivised to achieve the exit desired by the PE sponsor.

If the management holds shares in the target company, they are typically expected to reinvest a portion of their proceeds from the transaction to subscribe for shares in the bidding vehicle. In cases where the target company is subject to the Singapore Code on Take-overs and Mergers (the Take-over Code), this may give rise to special deals that require consultations with the Securities Industry Council of Singapore (SIC), which administers the Take-over Code. The PE sponsor may also set aside a portion of its shareholding in the bidding vehicle to establish a share incentive scheme where the shares are offered to management upon fulfilment of stipulated performance targets. Some PE sponsors may also make a distinction between classes of management personnel (i.e., between key management, who are instrumental to the operations and success of the target group, and the more rank-and-file management personnel, who are in charge of the day-to-day running of the business). The former would typically have a greater equity stake in the target group (through rollover arrangements and share option schemes) and may be delegated the discretion to
administer the equity incentive programmes for the latter, who might not be allocated equity stakes but might have some other form of reward-sharing (for instance, through bonus payouts or phantom share option schemes).

It is not uncommon for the PE sponsor to impose a moratorium or restrictions on transfers of equity held by the management in the target company or to subject the incentives received by the management to ‘good-leaver’ and ‘bad-leaver’ provisions in the event that the management leaves the employment of the target company. Such a moratorium or restrictions would usually be at least for a period that coincides with the anticipated time management would take to enhance the value of the target group and achieve an exit for the PE sponsor. The PE sponsor would normally also reserve the right to require the management to co-sell its shares in the target company to procure the sale of the entire share capital of the company in an exit event. Other additional terms that are commonly built into the employment contracts of the management are non-compete and non-solicitation provisions.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The transaction structure in an M&A transaction will depend on various factors, such as the eventual stake that the PE sponsor wishes to hold in the target company, timing and conditionality of the transaction. If the intention is to privatise a target company listed on the Singapore Exchange Securities Trading Limited (SGX), the transaction is likely to be structured either as a general offer subject to the Take-over Code or a scheme of arrangement (SOA) subject to both the Take-over Code and the Companies Act (Chapter 50 of Singapore) (the Companies Act). Briefly, the two structures differ in terms of timing, thresholds and outcomes.

In the case of a general offer under the Take-over Code, there is a timeline prescribed under the Take-over Code, to be adhered to once a firm intention to make an offer is announced by the bidding vehicle. This announcement triggers the obligation of the bidding vehicle to despatch the offer document to the target company’s shareholders (no earlier than day 14 and no later than day 21 after the offer announcement) and the target company is then obliged to respond with an offeree document (within 14 days of the despatch of the offer document). The Take-over Code also stipulates how long the offer can be kept open and the circumstances under which the offer can be extended. Depending on whether the general offer is made subject to specific conditions that are permitted by the SIC, the offer will either lapse as a result of the conditions not being satisfied, or close successfully.

An SOA generally involves a longer transaction timeline, mainly on account of the documentation required and the steps involved in the implementation of the SOA. Unlike the general offer process, where the offer document is driven by the offeror and is not subject to any review process, an SOA involves the preparation of a scheme document that requires the cooperation of the target company, as well as review by the SGX. The documentation and the SGX review process may take up to eight weeks following the joint announcement by the bidding vehicle and the target company of the proposed scheme. Once the scheme document is cleared by the SGX, the target company will have to apply to the High Court of Singapore (the High Court) for leave to convene a meeting of the shareholders to consider the scheme (the scheme meeting) and to give notice to shareholders to convene the scheme meeting. After the requisite approval is obtained at the scheme meeting, the target company will have to apply to the High Court again to sanction the SOA. The SOA will only become effective.
after the relevant court order is lodged with the Accounting and Corporate Regulatory Authority. Unless an objection is raised at the court hearing, an SOA is likely to take effect approximately four months after the initial joint announcement was made.

Except in the case of a partial offer, a general offer must be conditional upon an offeror receiving acceptances in respect of more than 50 per cent of the voting rights in the target company (although the acceptance threshold may be set at a higher level in a voluntary general offer, such as 90 per cent to achieve the right of compulsory acquisition under Section 215(1) of the Companies Act). An SOA is subject to the approval of a majority in number of shareholders representing 75 per cent in value of the members or class of members present, and voting either in person or by proxy at the scheme meeting.

A general offer under the Take-over Code does not necessarily result in privatisation, as that would depend on whether the offeror is able to invoke the right of compulsory acquisition under Section 215(1) of the Companies Act to ‘squeeze out’ the minority shareholders. On the other hand, an SOA offers an all-or-nothing result and may be the preferred route for PE sponsors that wish to acquire 100 per cent of the target company through a single transaction rather than end up with a majority stake in a listed entity (which is still subject to issues of potential minority oppression challenges, listing rules and other compliance requirements). If the target company is not a Singapore-incorporated company, the provisions in the Companies Act relating to SOAs and compulsory acquisition will not be applicable, in which case it will be necessary to examine the applicable legislation in the jurisdiction of incorporation of the target company to determine the appropriate take-private structure.

A going-private transaction in Singapore may also be structured as a voluntary delisting by the listed target company from the SGX pursuant to the listing rules of the SGX (the SGX Listing Rules), coupled with an exit offer typically made by an existing major shareholder of the target company. This structure may be preferred over a general offer if the primary objective is to delist the target company from the SGX (so that it is no longer subject to the SGX Listing Rules) regardless of whether 100 per cent of the target company is acquired by the close of the exit offer. In this regard, revisions were made to the voluntary delisting regime in July 2019 with a view to affording minority shareholders greater protection. Such revisions arguably render voluntary delisting coupled with an exit offer a less attractive privatisation option in certain circumstances (see Section IV).

The framework for acquisition of private companies by PE sponsors is dependent on the requirements or restrictions in the company’s constitution (the constitution) or the shareholders’ agreements between existing shareholders. The presence of pre-emption rights or tag-along or drag-along rights might hinder the speed, ease and flexibility with which the PE sponsor may implement the acquisition, as much would depend on whether the relevant consents or waivers can be obtained, or upon the timing in which these processes are carried out.

Tax-related issues tend to drive the deal structure (in particular, the holding structure and domicile of an acquisition vehicle) on a cross-border going-private or PE transaction, as parties seek to minimise the tax costs of the acquisition as well as tax leakages in the existing operations. Specifically, the impact of withholding taxes on dividends, local taxes, distributions and interest payments, and restrictions on the PE sponsor’s ability to repatriate earnings should be taken into account when structuring such cross-border transactions.

A PE sponsor looking to implement a leveraged transaction would also have to consider the laws in the jurisdiction where the target company and its assets are located, as these may prohibit or restrict companies in the relevant jurisdictions from providing financial assistance.
in the form of security arrangements or guarantees for the acquisition financing. These limitations may compel the PE sponsor to procure separate bank financing in a jurisdiction outside where the bidding vehicle is incorporated to provide the lenders with an appropriate security arrangement to support the credit assessment.

ii  Fiduciary duties and liabilities

As a general rule, a PE sponsor is entitled to act in its own interest in its capacity as a shareholder. The exceptions to this general principle are circumstances where the sponsor’s acts breach the provisions of the constitution (usually the minority protection provisions) or constitute minority oppression under Section 216 of the Companies Act. Section 216 of the Companies Act allows minorities to seek recourse in the courts where there is ‘oppression’ of a member; where a member’s interests are ‘disregarded’; or where there is a resolution or act that ‘unfairly discriminates’ against or is otherwise ‘prejudicial’ to a member. The common thread underlying Section 216 of the Companies Act is the element of unfairness and the court, in determining whether to grant relief under this provision, may take into consideration whether there was any disregard of the legitimate expectations of a member (which may arise otherwise than from the constitution). The court has wide powers under Section 216 of the Companies Act to remedy or put an end to the matters complained of.

The directors of a Singapore-incorporated company have fiduciary duties to act in the best interests of the company. If the company is listed on the SGX, its directors are also required to comply with the SGX Listing Rules, and with the principles and guidelines of the Code of Corporate Governance (the CG Code). The CG Code was revised in August 2018 and seeks to promote high levels of corporate governance in Singapore, as having good management practices will help to build investor and stakeholder confidence.21 Companies are required to describe their corporate governance practices with reference to the revised CG Code and how they conform to its principles (see Section IV).

When a PE sponsor appoints representatives as officers of portfolio companies, it should remind its representatives not to gain an advantage for themselves or any other person, or to cause detriment to the companies by virtue of their position as an officer of the companies. Such representatives should also not neglect the interests of minority shareholders while discharging their duties towards their appointer, and be especially careful not to be seen to abuse their position regardless of whether they have obtained information from the portfolio companies.

Under the Companies Act, the board of directors is also permitted to allow the disclosure of company information, whether by general or specific mandate, subject to the overarching consideration that there should not be any prejudice caused to the company. Thus, a director of a portfolio company who is a representative of a PE sponsor should be careful to obtain the board’s authorisation before he or she discloses the relevant information to the PE sponsor.

Where the portfolio company is listed on the SGX, the PE sponsor would be subject to the disclosure regime in the Securities and Futures Act upon becoming a substantial shareholder of the company (i.e., upon acquiring 5 per cent or more of the voting rights of the company) and when there is any change in the percentage level in its substantial shareholding, and the disclosure must be in a form prescribed by the Monetary Authority of Singapore (MAS). As the disclosure regime seeks to flush out the ultimate controllers of those

voting rights, PE sponsors should note that their fund set-up (including layers of holding companies, general partners, investment managers and even the founders) may become public information.

Under Singapore’s insider-trading laws, if a party is in possession of price-sensitive information (PSI) in relation to a company that is not generally available, that party is prohibited from trading (and from procuring another person to trade) in the company’s securities. A contravention of these laws may give rise to both civil and criminal liabilities. PSI is essentially non-public confidential information that, if it were generally available, a reasonable person would expect it to have a material effect on the price or value of the company’s securities (i.e., the information would or would be likely to influence parties that commonly invest in securities in deciding whether to trade or invest in the company’s securities). Given this broad definition, it is difficult to exhaustively list the types of information that would be regarded as PSI for the purposes of insider trading laws. One obvious example would be a profit forecast or financial projections of the target company that have not been made known publicly. Thus, where a PE sponsor is conducting due diligence on a potential target company, it should be circumspect in requesting information and mindful not to obtain PSI, unless the target company is prepared to disclose that PSI in the public domain before the PE sponsor deals in the securities of the target company.

III YEAR IN REVIEW

i Recent deal activity

Singapore has maintained its status as the region’s leading dealmaker, with transactions and deal values surpassing figures in Malaysia and Indonesia.22 The list of high-profile M&A deals in Singapore in 2019 includes:

a GIC’s US$11 billion acquisition of Ultimate Software Group Inc, as part of an investor group led by Hellman & Friedman and comprising Blackstone Group LP, Canada Pension Plan Investment Board and other investors;23
b GIC’s and Brookfield Infrastructure’s acquisition of Genesee & Wyoming Inc for US$8.4 billion;24
c Temasek Holdings’ sale of the Ascendas-Singbridge group of companies to CapitaLand Limited for US$8.1 billion;25
d Temasek Holdings’ proposed acquisition of a 30.55 per cent stake in Keppel Corporation for S$4.08 billion;26 and
e YY Inc’s US$1.5 billion acquisition of Singapore-based Bigo Technology Pte Ltd.27

22 See footnote 4.
23 See footnote 14.
24 See footnote 15.
25 See footnote 19.
26 See footnote 16.
27 See footnote 12.
Financing

Financing structures – debt financing

Acquisition financing for PE transactions in Singapore continues to be achieved primarily by way of debt financing, with equity investment by management and investors and other forms of financing taking on a less prominent role. On balance, debt financing provides greater certainty of funding (primarily through the use of ‘certain funds’ provisions in debt financing agreements) and also a means for acquisition even where an acquirer does not possess sufficient funds or does not wish to pay the entire price out of its own funds up front. The certainty offered by debt financing is usually preferred in light of the requirement of confirmation of financial resources and the (relatively limited) financing conditions in acquisition facility agreements (see below for further discussion of this requirement of confirmation of financial resources). The continued use of debt financing is also reflective of the sustained liquidity and availability of funds from traditional lending sources. Therefore, despite the varied forms of financing available, debt financing remains dominant in the acquisition financing space.

The typical debt-financing structure used by PE firms to finance an acquisition is the leveraged buyout. The debt is usually expected to be senior and secured by the assets of the target company and the target company’s subsidiaries, with debt repayments being made by the target company through its own resources or future debt refinancing.

Given the involvement of the target company in the financing structure, financial assistance restrictions in Singapore present additional issues for leveraged buyouts and other financing arrangements that are secured by assets, or expected to be repaid from the cash flow, of the target company or its subsidiaries if the target company is, or remains, a public company or a subsidiary of a public company. These financial assistance restrictions and their continued application in certain situations are discussed further below.

Security

Financiers typically look to the assets of the target group in seeking to maximise its collateral pool. The scope of the security package is fundamentally premised on the availability of the target group’s asset pool and the feasibility of taking security over those assets (bearing in mind the legal prohibitions and restrictions applicable to the relevant security providers and assets in question across each relevant jurisdiction, including financial assistance issues). Therefore, the feasibility and practicability of taking security over the target group’s asset pool must be carefully considered, especially if the target group’s assets are located across multiple jurisdictions (as issues of dealing with local law requirements arise). Financiers may also require additional safeguards in the form of corporate or individual guarantees from, or the provision of other support arrangements by, parties and sponsors related to the acquirer.

Timing-wise, security or guarantees from the target group are generally expected to be in place only on and from completion of the acquisition, as the acquirer would typically not have control over the target group prior to that stage and financial assistance restrictions may (to the extent that the target company remains a public company or a subsidiary of a public company) apply. As such, depending on the security matrix, clean-up periods may feature in financing documentation to allow time for the provision of security and guarantees by the target group. The length of the clean-up period would depend on the extent to which the acquirer has been able to appraise the assets of the target group and the restrictions (legal, contractual or otherwise) and encumbrances thereon. To the extent that such an appraisal prior to completion is not practicable, the provision of security and guarantees by the target group must be assessed and clean-up periods adjusted accordingly. This period, however, is
generally truncated in situations where the target is not a public company or a subsidiary of a public company such that financial assistance restrictions do not apply and where the acquirer has sufficient visibility over the target group’s assets for appraisal prior to completion.

Where security arrangements are expected to be in place relatively quickly upon or following the completion of the acquisition, the form of the security documents would also have been negotiated and, if possible, agreed beforehand. In situations where the target’s assets cannot be perfected within a practical time frame (which may be the case if the assets are situated in multiple jurisdictions with differing legal systems), bridging guarantees or indemnities are sometimes sought from the sponsor to protect the financiers against any losses due to the non-perfection of security, with such guarantees or indemnities released once all security comprising the security package has been perfected.

Confirmation of financial resources and certain funds

In a transaction governed by the Take-over Code, the financial adviser to the acquirer is required to issue a confirmation of financial resources. Hence, in the context of debt financing (which is typically subject to an extensive list of conditions precedent), conditions precedent to the utilisation of any bridge loan used to finance an acquisition, and particularly a takeover offer, must be kept to a minimum to ensure certainty of funding (i.e., that funds are available, when required, to satisfy settlement of acceptances of the offer). Clauses or conditions that could constitute a draw-stop and allow the financier to walk away from its commitment may also not be feasible in these circumstances.

Financing structures – other financing methods

Several alternative types of financing structures that have been utilised in acquisition financing (involving a larger quantum) include the following.

Mezzanine debt and direct lending

Apart from senior debt that has typically formed the lion’s share of the entire debt package, the introduction of a mezzanine tranche is not uncommon and, if advanced, is typically provided by financial institutions or direct lending arms of funds. The mezzanine tranche may be contractually subordinated in terms of priority of repayment and security by way of a subordination agreement, and may also be structurally subordinated to the senior tranche. In return, mezzanine lenders and direct lenders expect a higher margin and incentives via equity kickers such as options to subscribe for shares in the acquirer or offeror at prescribed points. Payment-in-kind tranches of mezzanine debt may also be adopted where interest is capitalised during the life of the facility, resulting in higher and more attractive returns to mezzanine lenders. Further, financial covenants in mezzanine debt may be more relaxed and, when employed in a debt package alongside senior debt, commonly allow for breaches of senior debt financial covenants to be resolved in collaboration with senior lenders without unnecessary interference by the mezzanine tier.28 The use of mezzanine tranches or mezzanine financing terms may be seen in acquisition deals where senior debt is not sufficiently available from traditional lending sources for the purposes of the acquisition, which necessitates further alternatives in financing sources.

28 PLC, ‘Mezzanine finance in leveraged transactions’.
**Fund-level financing**

Debt financing has increasingly been taken at the PE fund level, primarily to complement the use of debt at the level of the portfolio company. Motivations that PE funds have for turning to debt financing at the PE fund level include lower cost of debt (as lenders find greater comfort in multiple income streams and a diversified pool of collateral by virtue of taking security over the PE fund’s multiple portfolio companies), the ability to draw on the debt facility quickly (as this obviates the need to arrange for debt facilities at the portfolio company level contemporaneously with the anticipated acquisition, circumventing the complex issues that may arise from the taking of security at the target level) and possible decreased transaction costs from arranging only one debt facility per PE fund (as opposed to target-level debt facilities being arranged for each acquisition).

A PE fund that wishes to take up fund-level financing can look to either net asset value (NAV) debt facilities or subscription debt facilities. While lenders of the former look downwards to the investments of the PE fund as the primary source of repayment, those of the latter look upwards to the unfunded capital commitments of the PE fund for assurance. A hybrid of both structures has also been explored, where the proportion of the borrowing base made up of unfunded capital commitments as against NAV changes over time; as capital commitments are called upon and the capital contributions are used to acquire investments, the NAV of those investments may potentially enhance the borrowing base. The increasing emphasis and interest in environmental and social responsibility has also led to the securing of a revolving facility with its borrowings’ interest rate pegged to the sustainability performance of the PE fund in a world first.29

One consideration that may arise in a subscription debt facility is that of the confidentiality of the partners in the PE fund: if the fund is structured as a limited partnership, perfection of security over the unfunded capital commitments of the fund would, under Singapore law, require notices to be delivered to each limited partner and evidence of the delivery would invariably be required by the financiers. Therefore, where confidentiality is paramount, NAV debt facilities may be the more suitable option.

**Bonds**

In larger financing transactions, mezzanine debt may be replaced or refinanced by high-yield bonds. As the minimum size of a high-yield bond issue usually falls within the higher region to create sufficient liquidity within the issue, the use of this method of financing has been restricted to higher-valued buyouts. Bond issuance for the purposes of funding an acquisition is relatively less prevalent because of the fluctuating and changing nature of the bond market (which may be insufficient to satisfy certainty of funding requirements) and is commonly utilised as a post-acquisition or refinancing option. However, where the market is favourable, bond issuances, which are traditionally less restrictive than debt financing, have been seen as a viable alternative.

In the Singapore market, apart from situations where institutional acquirers or strategic investors utilise bond issuances as a method to raise financing to fund acquisition war chests,

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bond issuances have also been used in the context of going-private transactions where the target company is known in the market and has existing bond issuances or other debt that has to be refinanced, whether as a result of maturity or as a result of change-of-control triggers.

**Composite financing structures**

In recent years, certain take-private deals involving a larger quantum of acquisition debt have been structured with a composite of various financing sources, coupled with the flexibility to incur additional debt that may then be brought within the existing acquisition financing structure. A typical composite structure involves a senior facility coupled with either one or more other facilities (mezzanine or otherwise), bond issuances and the ability to either increase borrowing limits or bring new facilities into the existing structure. In such structures, security sharing, subordination and inter-creditor terms are pertinent issues that form the subject of fairly involved negotiations. As a practical measure, the target group’s existing financiers may also be invited to participate in the composite structure to, among other things, manage the risk of those existing lenders triggering prepayment or default provisions as a result of the acquisition.

**Financial assistance**

With the 2015 amendments to the Companies Act, issues that arise from the restriction on target companies providing financial assistance in connection with the acquisition of their own shares, which traditionally represented roadblocks in acquisition financing as ‘whitewash’ procedures needed to be carried out before these companies can start to provide upstream security and income, have been significantly alleviated due to (1) the abolition of the restriction as regards private companies (which are not subsidiaries of a Singapore public company), and (2) the introduction of a relatively simple whitewash procedure. As such, traditional challenges in structuring deals for PE investors, such as processing time and cost, may be addressed to some extent.

On the private company front, restrictions on a private company (which is not a subsidiary of a Singapore public company) providing financial assistance in connection with the acquisition of its own shares were lifted, easing debt pushdowns and the provision of security by targets and their subsidiaries that have been successfully taken private as these companies no longer have to undergo whitewash procedures to provide financial assistance in the acquisition of their shares. With this relaxation, financiers have endeavoured to obtain security and guarantees at the target level promptly upon the completion of the acquisition or within shorter clean-up periods. This, however, remains restricted to deals where the target company is a private company (which is not a subsidiary of a public company) and is subject to the acquirer’s appraisal of the target group’s assets.

As for Singapore public companies and their subsidiaries, while financial assistance restrictions continue to apply to, and remain live and key issues in, acquisition deals, alleviating these concerns is a relatively new whitewash procedure to allow transactions that would otherwise be unlawful financial assistance; Section 76(9BA) of the Companies Act was introduced as part of the 2015 amendments to the Companies Act as an alternative to the conventional whitewash procedures. Adapted from Section 260A(1)(a) of the Australian Corporations Act 2001, Section 76(9BA) of the Companies Act allows financial assistance to be provided if, among other requirements, the following are fulfilled:

- the provision of financial assistance does not materially prejudice the company’s or its shareholders’ interest, or the company’s ability to pay its creditors; and
the company’s board of directors resolves that the company should provide financial assistance and that the terms for doing so are fair and reasonable to the company.

Section 76(9BA), therefore, serves as a relatively simpler alternative to traditional whitewash procedures, which are subject to challenges and limitations, such as the imposition of personal liability for solvency statements, extended timelines and shareholder approval.

The target company must be prepared to show an absence of material prejudice if it wishes to provide financial assistance to the acquirer. Whether or not financial assistance is given depends on where the net balance of the financial advantage lies as determined on an assessment of all its interlocking elements and this would also include an examination of the commercial realities of the transaction. The elements of ‘financial assistance’ and ‘material prejudice’ are thus linked: financial assistance to the acquirer is effected by transferring net value to the acquirer, which may (as suggested by Australian authorities) ipso facto be prejudicial to the company whose shares are being acquired, its shareholders or its creditors. Australian authorities suggest that the following non-exhaustive assessments may be taken into consideration in determining the question of whether material prejudice exists:

- a qualitative assessment of the impact of the transaction, taking into account:
  - the purpose of the transaction; and
  - the nature of the transaction; in particular, whether it involves any actual or contingent depletion of the company’s assets;
- a quantitative assessment (based on the company’s financial statements, etc.) of the impact of the transaction on the company’s assets, future profitability, future cash flow and balance sheet;
- the opinion of the directors or any independent experts on the impact of the transaction; and
- the consequences of the transaction on the interests of the company, its shareholders or its creditors after the giving of the financial assistance.

The disjunctive reference in the statutory provision to ‘the company or its shareholders’ necessarily involves a consideration of the company’s position independent of that of the shareholders, but in scenarios where the interests of the company and its shareholders are not aligned, Australian case law suggests that little heed is paid to the interests of the shareholders when determining if material prejudice exists. That said, shareholder interest is not completely ignored; dicta from a recent Australian case suggests that a dilution of shareholder equity would constitute material prejudice to shareholders even if the company’s assets remain unchanged. As for creditors’ interests, it is suggested that a likelihood that the company’s ability to pay its creditors will be reduced, even if the company remains solvent, would be materially prejudicial.

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32 DuluxGroup, In the matter of DuluxGroup Ltd [2019] FCA 961 at [50].
34 id., at [26].
35 ibid.
Institutions in Singapore have initially taken a cautious approach in relying on Section 76(9BA) during its infant stages, pending greater clarity and guidance on the precise meaning of ‘material prejudice’. However, in recent years, the no-material-prejudice whitewash method has gained traction and is increasingly used in Singapore acquisition financings as acquirers seek to take advantage of this relatively succinct procedure, bearing in mind the time and cost savings as compared to traditional whitewash methods.

**Exit strategies in the financing context**

While the exuberant PE exit environment in preceding years appears to have stabilised in terms of volume, the changing geopolitical landscape has spurred PE investors to take greater pre-emptive steps to prepare for the likelihood of exiting their investments within a short time frame or in an unplanned scenario. This change can, in greater part, be attributed to geopolitical uncertainty, macroeconomic volatility and technological advances, all of which will have an impact in formulating exit decisions by PE investors.

Specifically in the financing context, debt financing terms that have seen increasing scrutiny and amendments include extension of maturity dates, pricing, financial covenants and prepayment events. These are usually renegotiated should more time be needed before exiting the investment, to allow the PE investor to achieve a partial exit or return from the investment or, in the case where the target group has tapped, or intends to tap, the bond market, to bring the debt financing terms in line with the bond terms (which are generally more favourable) as much as possible.

### iii Key terms of recent control transactions

As more countries develop their own merger control regime and with potential targets having globalised businesses, antitrust and merger control issues are usually one of the first few important issues that PE investors have to consider when assessing the viability of a take-private transaction. The merger control analysis is heavily dependent on access to the target’s data and a lengthy merger control review can present significant delays for the transaction timeline and challenges for certainty of transaction. Because of the potentially lengthy process of merger control filings, takeovers of listed companies have to be structured as an SOA or a pre-conditional general offer (where a formal offer is made only upon fulfilment or waiver of certain pre-conditions). A long execution period will in turn translate into higher financing cost because financial resources confirmation has to be provided at the time of announcement of the SOA and pre-conditional general offer (though this is not strictly required under the Take-over Code).

Another increasingly common issue is whether the transaction is subject to approval from Committee on Foreign Investment in the United States (CFIUS), an arm of the US government that reviews certain corporate transactions to determine if the transaction results in ‘control’ of a US business by a non-US entity and whether the transaction raises national security concerns. Though filing with CFIUS is a voluntary regime, CFIUS may unilaterally initiate a review of a transaction even after it has closed. If a contemplated transaction falls within CFIUS’s review jurisdiction, parties would have to weigh the costs and benefits of filing a voluntary notice with CFIUS versus not filing one. The former approach results in higher

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costs and delays but achieves the certainty that the transaction will be free from future CFIUS interference while the latter avoids the costs and delay but faces the risk that if CFIUS initiates a review in the future, the transaction may be blocked or that a consummated transaction be unwound.

In making an exit, a PE sponsor that is seeking to exit in line with its investment time frame would be likely to prioritise certainty of closing. If the sale is conducted by way of an auction, a bidder that is able to commit to a ‘sign and close’ would be expected to be a front runner in the process. In these circumstances, the only closing conditions that are likely to be acceptable would be those related to regulatory approvals (e.g., merger control) that are truly essential, and even then, only when it is fairly certain that the approvals would be forthcoming.

If a takeover offer is for a publicly listed company in Singapore, the offeror may decide to revise the offer price to encourage more acceptances, especially if the independent financial adviser of the target company has opined that the offer price is not fair. In addition, the offer price may also be adjusted for dividends declared or paid during the offer period. Post-completion audits and consequential purchase-price adjustments are more common in the sale of private companies, especially where there is a reasonable time gap between the evaluation of the deal consideration (which may be earlier than the date of signing of the purchase agreement) and completion of the transaction. A PE sponsor that is seeking to exit its investment and return the proceeds to its investors would be concerned about the certainty and finality of closing; it may not be too keen on post-completion purchase price adjustments, and thus may prefer a ‘locked-box’ approach to the purchase price. However, it may not be able to insist on such a preference if the purchaser is also in a fairly equal bargaining position, and this should not be a deal-breaking issue, especially if there is a potential upside adjustment for the PE sponsor (for instance, where the performance of the company is seasonal and the period in respect of which post-completion audit takes place falls during the months when the target company traditionally performs better).

IV REGULATORY DEVELOPMENTS

The main regulatory bodies that have oversight of M&A activities in Singapore are the SIC and the SGX where the deal involves SGX-listed companies. The MAS is also relevant as the industry regulator for fund management companies.

i SGX – voluntary delisting regime

On 11 July 2019, the Singapore Exchange Regulation (SGX RegCo) announced various amendments to the voluntary delisting regime for issuers listed on the SGX Securities Trading Ltd (SGX-ST), which took immediate effect. These amendments followed the public consultation conducted by SGX RegCo in the fourth quarter of 2018, and seek to provide minority shareholders with greater protection and better exit offers.

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37 ‘SGX RegCo requires exit offers to be fair and reasonable, shareholder vote to exclude offeror and concert parties’ (11 July 2019): https://links.sgx.com/FileOpen/20190711_SGX_RegCoRequiresFairAndReasonableExitOffers_FINAL.ashx?App=Announcement&FileID=560923.


39 ibid.
Under the previous voluntary delisting regime, an issuer could be voluntarily delisted from the SGX-ST if, inter alia, the voluntary delisting resolution (VDR) was approved by a majority of at least 75 per cent and not voted against by 10 per cent or more of the total number of issued shares (excluding treasury shares and subsidiary holdings) held by shareholders present and voting at the meeting. The company’s directors and controlling shareholders were not required to abstain from voting on the VDR. In addition, the exit offer had to be reasonable and should normally be in cash.

Under the revised delisting regime, the offeror and parties acting in concert with it are required to abstain from voting on the VDR. Such change is aligned with the approaches in Hong Kong and Australia, where minority investors ultimately determine the voting outcome.40 Arising from the feedback garnered in the public consultation, the right of a 10 per cent minority to block a VDR (10 per cent Block) has been removed, while the 75 per cent approval threshold is maintained. Further, to afford shareholders better exit value, an exit offer in conjunction with voluntary delisting must not only be reasonable but must also be fair,41 and the issuer’s independent financial adviser (IFA) must opine that the exit offer is fair and reasonable.42 The SGX expects the bases for determining the fairness and the reasonableness of exit offers to be separately detailed by IFAs, to ensure that IFA opinions are well understood by investor.43 Finally, the new regime also codifies the pre-existing practice by requiring the exit offer to include a cash alternative as the default alternative.44

The SGX has highlighted that offerors should not use other forms of privatisations to avoid complying with the new requirements. As such, where a general offer is made, the SGX will generally consider waiving the exit offer and shareholder vote requirements if the offer is fair and reasonable, and at the close of the offer, the offeror has received acceptances from at least 75 per cent of the independent shareholders.45 If the free float is lost by the close of the offer and the waiver conditions are not met, the issuer will remain listed and SGX RegCo may suspend trading of its securities.46 In the meantime, the issuer must fulfil its continuing obligations under the SGX Listing Rules.47 In a scenario where the SGX does not permit the target company to be delisted and the free float is not restored, the offeror and the target company would arguably be left in limbo. The issuer will only be able to delist if a subsequent general offer that meets the waiver conditions is made, or if it enters into an SOA that complies with the SGX Listing Rules.48

The amendments to the regime are likely to raise the costs of privatisations generally, and may render voluntary delisting coupled with an exit offer a less attractive option for a PE sponsor acting in concert with the existing controlling shareholders of a company to privatise the company. That being said, the abolition of the 10 per cent Block has the balancing effect

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41 See footnote 37.
42 ibid.
43 ibid.
44 Rule 1309(1)(b) of the SGX Listing Rules.
45 See footnote 37.
46 ibid.
47 ibid.
48 ibid.
of ensuring that the power accorded to minority shareholders is not unduly disproportionate. In appropriate cases, this may increase the viability of a VDR in conjunction with an exit offer as a privatisation option.

### ii CG Code

On 6 August 2018, the MAS issued a new CG Code (along with a new Practice Guidance), which came into effect on 1 January 2019. Consequential amendments were also made to the SGX Listing Rules, which took effect from the same date with the exception of certain provisions that will only come into force on 1 January 2022.

The revised CG Code comprises principles (which are overarching and non-disputable statements that embody the fundamentals of good corporate governance with which companies must comply) and provisions (which are actionable steps to guide companies in complying with the substance of the principles). Compliance with the principles is mandatory under the amended SGX Listing Rules, and variations from the provisions are acceptable only insofar as the companies explicitly state and explain how their practices are consistent with the intent of the relevant principles. Some of the key changes are that the re-appointment of independent directors who have served beyond nine years will be subject to a two-tier vote to be approved by the majority of (1) all shareholders; and (2) all shareholders excluding shareholders who also serve as directors or the CEO (and their associates); a majority of the board (instead of ‘at least half’ as previously) should comprise independent directors where the chairman is not independent; and non-executive directors must make up a majority of the board. Certain core corporate governance practices stipulated in the revised CG Code are also contained in the SGX Listing Rules, rendering compliance with these requirements mandatory.

As part of the continuous endeavour to level up corporate governance standards and practices, strengthen investors’ confidence and uphold Singapore’s reputation as a trusted international financial centre, the MAS established the Corporate Governance Advisory Committee on 12 February 2019. This permanent, industry-led body will identify current and potential risks to the quality of corporate governance in Singapore and monitor international trends, revise the Practice Guidance to clarify the GC Code and recommend updates to the CG Code.

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50 SGX-ST, ‘Transitional Practice Note 3 – Transitional Arrangements Regarding Code of Corporate Governance 2018’. The first of the provisions that will come into force on 1 January 2022 requires at least one-third of the board to comprise independent directors. The second stipulates that the continued appointment of independent directors who have served beyond nine years must be approved in two separate resolutions, by the majority of (1) all shareholders; and (2) all shareholders excluding those who serve as directors or the CEO (and their associates).


52 ibid.
Take-over Code

In January 2019, the MAS revised the Take-over Code to clarify its application to companies with dual class share structures (DCS companies) and a primary listing on the SGX-ST. The revisions took effect on 25 January 2019 and were implemented on the advice of the SIC and following a public consultation.53

Prior to the revisions, a shareholder may be obliged to make a mandatory offer under the Take-over Code if his or her voting rights in a DCS company increase beyond the mandatory offer thresholds in the Take-over Code as a result of (1) a conversion of multiple vote (MV) shares into one vote (OV) shares; or (2) a reduction in the number of voting rights per MV share, which lowers the total number of voting rights in the DCS company.54 The amendments to the Take-over Code clarify that the mandatory offer requirement will be waived where the shareholder in question is independent of the conversion or reduction event.55 In addition, even if the shareholder is not independent as such, the mandatory offer requirement will be waived if he or she reduces his or her voting rights to below the mandatory offer threshold, or obtains the approval of independent shareholders to waive their right to a mandatory offer within a specified time.56

The amendments to the Take-over Code also seek to afford greater certainty for the market and safeguards for minority shareholders. They provide that, where an offeror makes an offer for a DCS company, the offer price for MV shares and OV shares should be the same if the traded prices are not available for all the classes of shares, and the different classes of shares differ only in terms of their voting rights.57 The revised approach provides greater certainty to market participants and potential offerors.58 It also serves as a safeguard for holders of OV shares by ensuring that they are likewise entitled to any premium paid to holders of MV shares.59

New structure for funds – Singapore variable capital companies

In a bid to strengthen Singapore's position as an international fund management and domiciliation centre, the MAS and the Accounting and Corporate Regulatory Authority of Singapore have introduced a new corporate structure for investment funds, the Singapore variable capital company (S-VCC), following public consultation in March 2017. The Variable Capital Companies Act 2018, which was passed by the Singapore Parliament on 1 October 2018, came into effect on 14 January 2020. The S-VCC corporate structure can be used for a wide range of investment funds and provides fund managers enhanced operational

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54 ibid.
55 ibid.
56 ibid.
58 ibid.
59 ibid.
flexibility and cost savings. In terms of eligibility, the structure may currently only be adopted by funds managed by a licensed or registered fund manager, or an exempt fund manager that is otherwise regulated as a financial institution.\(^{60}\)

The flexible corporate entity can be used by both open-ended and closed-ended investment funds, and by both traditional and alternative fund managers for strategies such as PE.\(^{61}\) In addition, fund managers may incorporate new S-VCCs or re-domicile their existing investment funds with comparable structures by transferring their registration to Singapore.\(^{62}\) Apart from being able to pay dividends using capital, an S-VCC may also issue and redeem shares without seeking shareholders’ approval, affording investors the flexibility to enter into and exit from their investments in the fund when they wish to.\(^{63}\) The S-VCC framework further allows for cost savings from the centralised fund management and domiciliation activities, and helps fund managers to structure their funds more efficiently.\(^{64}\) An S-VCC may be established as a stand-alone structure, or an umbrella structure with multiple sub-funds that may have different investment objectives and investors, as well as assets and liabilities.\(^{65}\)

While sub-funds have their own set of investors, they do not have separate legal personalities.\(^{66}\) To safeguard against the risk that the assets and liabilities of one sub-fund could be commingled with those of another, assets and liabilities of each sub-fund are required to be segregated, such that the assets of one sub-fund may not be used to discharge the liabilities of another, or of the umbrella fund, including in the event of insolvency.\(^{67}\) This enables sub-funds under the same S-VCC to pursue differing investment objectives while ensuring that investors in each sub-fund are shielded from liabilities in respect of other sub-funds.

To accelerate industry adoption of the S-VCC framework in Singapore, the MAS has rolled out a grant scheme, which is valid for three years, to help defray up to 70 per cent of the cost of incorporating or registering an S-VCC, capped at S$150,000 for each application, with a maximum of three S-VCCs per fund manager.\(^{68}\) Industry players have applauded the launch of the S-VCC framework for deepening the ecosystem and enhancing Singapore’s role as Asia’s gateway for fund managers and investors.\(^{69}\) In the pilot programme conducted in the last quarter of 2019, the 18 participating fund managers incorporated or re-domiciled a total of 20 investment funds as S-VCCs through the initiative. These investment funds comprise VC, PE, hedge fund and environmental, social and governance (ESG) strategies.\(^{70}\) As a whole, the S-VCC framework is poised to be

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62 ibid.


64 See footnote 61.

65 See footnote 63.


67 See footnote 63.

68 See footnote 60.

69 ibid.

70 ibid.
a game-changer for Singapore's fund management industry, by offering a wider choice of investment fund vehicles in Singapore, which caters to the needs of global investment funds and investors.

V OUTLOOK

Persisting tensions between the United States and China, potential global conflicts, global regulatory scrutiny of Chinese investments and technology-led innovations that are disrupting all sectors present some of the key challenges to regional M&A activity in 2020.71 The coronavirus outbreak at the beginning of 2020 adds to the uncertain economic outlook for this year. It also puts a brake on China's already slowing growth and China's sudden, virtual stoppage of economic activities is likely to involve adverse spill-over effects, which may cascade into a global economic impact.72

For Singapore, domestic deal activity remained strong in 2019 despite a decline in the local economy.73 This has been attributed to the strong influx of capital from international institutions and continued investment activity by the city state's government-linked funds.74 The political instability in Hong Kong has also strengthened Singapore's position as a safe haven for global investors.75 While Singapore's economy will no doubt be impacted by the coronavirus, the government is confident that the local economy is diversified enough to mitigate uncertainty76 and it is ready to put in place strong support measures for enterprises and workers to mitigate the fallout.77 If past results shed any light on the future, the outbreak is likely to be followed by an eventual bounce back. As a whole, Singapore's performance on the economic stage in 2020 will depend on a blend of factors, not least its ability to optimise its crisis response.

Pending economic data on the virus' impact, the trends to date paint a generally optimistic landscape of PE/VC in the region. Ernst & Young reported that 67 per cent of Asia-Pacific executives are seizing upon the digital and technology imperative and enhancing their capabilities in such assets, including through corporate VC funds and external funds to invest in various new technologies.78 According to Preqin, there is over US$250 billion of capital committed to PE in Asia,79 and Reuters has reported that PE firm KKR is targeting

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71 Ernst & Young, 'Global Capital Confidence Barometer', October 2019, 21st edition, Asia-Pacific highlights.
73 Baker McKenzie, 'Global Transactions Forecast 2020 – Singapore'.
74 Herbert Smith Freehills, 'M&A in 2020: The New Normal'.
75 See footnote 2.
a record US$15 billion for a new Asia-focused buyout fund. Closer to home, South East Asia continues to nurture promising and prominent unicorns that have disrupted their respective sectors, such as Singapore-based transport technology and mobile application company Grab and Indonesia-based Traveloka and Tokopedia. In addition, within just three months, Temasek's Azalea Investment Management has closed its inaugural PE fund with US$650 million, surpassing its original target of US$400 million. One developing trend that will impact investment decisions by PE funds is the incorporation of ESG initiatives as part of the investment process. With increasing awareness of ESG considerations and financial data indicating that ESG integration may lead to better returns, more PE firms have adopted ESG principles as part of their investment strategies. Temasek, which is owned by the government of Singapore, has announced its intentions to be more aggressive in achieving its climate change goals as it puts ESG principles at the heart of its investment strategies. It is also encouraging that Quadria Capital, a Singapore-based healthcare-focused PE sponsor, became the first PE fund in the world to secure 'sustainability improvement capital call facility' from ING. The interest rate of such facility is pegged to the improvement of the sustainability impact of the investment portfolio.

As the world’s economy faces mounting uncertainty that is likely to curb overall appetite for dealmaking, Singapore’s economy will have to persist in braving global headwinds in the coming year. It remains to be seen how the city state will navigate the macroeconomic vagaries, leverage its strategic position as South East Asia’s choice investment hub and harness the power of digital technologies, to remain responsive to global trends and ride the wave.

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81 See footnote 9.
84 'Temasek may get "more aggressive" on green goals' (25 January 2020): www.straitstimes.com/business/economy/temasek-may-get-more-aggressive-on-green-goals.
86 ibid.
Chapter 16

SOUTH KOREA

Chris Chang-Hyun Song, Tong-Gun Lee, Brandon Ryu, Joon Hyug Chung, Alex Kim and Dong Il Shin

I OVERVIEW

i Deal activity

In recent years, growth in the South Korean M&A market has been primarily driven by cross-border M&A transactions; in particular, there has been a significant surge in outbound M&A transactions. 2018 saw 86 outbound M&A transactions, which was a 153.4 per cent increase on 2017. Likewise, there was a total of 48 inbound M&A transactions in 2018, reflecting a 33 per cent increase on 2017. There were 401 domestic M&A transactions in 2018; while domestic M&A transactions occupied the lion’s share of all M&A transactions for that year, the growth rate compared with 2017 was relatively low at 6.7 per cent. For 2019, there were a total of 44 outbound M&A transactions for the first three quarters of the year; this figure represents a 10.6 per cent increase compared with the same period in 2018. Inbound M&A transactions for the first three quarters of 2019 also increased by 11.1 per cent compared with the same period in 2018. Domestic M&A transactions still accounted for the largest number of M&A transactions for the first three quarters of 2019; however, with 262 transactions on record, these saw a 21.3 per cent decrease compared with the same period in 2018. The takeaway here is that while domestic M&A transactions continue to account for the largest slice of the M&A market in South Korea for now, cross-border M&A transactions, especially outbound M&A transactions, are on the rise.

Compared with 2018, which was a record year in terms of transaction volume as well as transaction value, the M&A market slowed down in 2019. The first three quarters of 2019 saw a 17.2 per cent decrease in terms of transaction value and an 8.4 per cent decrease in terms of transaction volume compared with the same period in 2018. Noteworthy cross-border transactions for 2019 include SKC’s sale of its chemical division to Kuwait’s state-owned PIC for a total of US$442 million, as well as IMM Private Equity’s acquisition of Linde Korea Co Ltd from Linde AG for a total of US$1.17 billion. On the domestic side, Korea Shipbuilding & Offshore Engineering Co Ltd’s acquisition of Daewoo Shipbuilding & Marine Engineering Co Ltd for US$4.5 billion is considered one of the most notable transactions of 2019.

1 Chris Chang-Hyun Song, Tong-Gun Lee, Brandon Ryu and Joon Hyug Chung are partners and Alex Kim and Dong Il Shin are associates at Shin & Kim.

2 All statistics on the value and volume of M&A deals in Korea involving private equity funds were retrieved from Mergermarket. They are based on M&A deals announced for the given year (the announcement is based on the signing date), some of which have not disclosed the size of investment; the statistics take into account only direct investments by private equity funds and not those done through special purpose vehicles.

3 Mergermarket, South Korea M&A activity, Q1–Q3 2019 trend report.

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In 2018, there were 535 M&A transactions in terms of volume, with the total deal value amounting to US$68.7 billion; these figures represent a substantial increase compared with 2018, for which, in terms of volume, 360 deals were recorded, with a total deal value of US$41.6 billion.4 There were several large-scale deals that boosted the total deal value in 2018, with a noteworthy example being the KCC consortium's US$3.1 billion acquisition of US-based Momentive Performance Materials. This deal was also ranked as the most highly valued outbound deal of 2018 by Korean entities. The technology, media and telecommunications sector also saw a noticeable increase in M&A activity in 2018 on the back of a US$4 billion intra-group merger deal between CJ O Shopping and CJ E&M. Likewise, the financial services sector saw a remarkable increase in M&A deal value following the announcement of Shinhan Financial Group's acquisition of a 59.15 per cent stake in Orange Life Insurance from MBK Partners for US$2.2 billion.

Overview of private equity funds activity

Offshore private equity funds (foreign PEFs) became active in Korea during the immediate aftermath of the Asian financial crisis of 1997. They were followed by the emergence of onshore private equity funds (Korean PEFs) a decade later, with the introduction of the Financial Investment Services and Capital Markets Act (FSCMA) in 2007. Currently, all aspects of PEF activities, ranging from fundraising and investment, to exits, are robust and continuing to increase in Korea. Furthermore, the current administration is also seeking to alleviate PEF registration and investment requirements by amending the FSCMA; in addition, a significant amount of fresh policy-driven capital in the form of the Growth Ladder Fund as well as the Corporate Structure Innovation Fund promises to further fuel PEF activities. Based on these factors, the growth trend of PEF activity in South Korea is expected to continue in the coming years.

In 2019,5 there were 66 acquisition deals worth US$8.92 billion in value sponsored by PEFs. With respect to exit deals by PEFs, there were 23 deals worth US$3.86 billion (excluding initial public offerings (IPOs)). The table below shows the annual aggregate deal volume and deal count for acquisitions and exits by PEFs in 2007, 2018 and 2019.

<table>
<thead>
<tr>
<th>Year</th>
<th>Acquisitions</th>
<th>Exits (excluding IPOs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deal value (US$ billion)</td>
<td>Deal volume</td>
</tr>
<tr>
<td>2019</td>
<td>8.92</td>
<td>66</td>
</tr>
<tr>
<td>2018</td>
<td>7.70</td>
<td>91</td>
</tr>
<tr>
<td>2007</td>
<td>4.86</td>
<td>13</td>
</tr>
</tbody>
</table>

A breakdown of PEF-driven acquisitions in terms of transaction numbers according to price bracket shows that in 2018, there were 18 acquisitions in the US$100 million to US$500 million range, accounting for 19.8 per cent of the total PEF-driven acquisitions; there were two acquisitions in the US$500 million to US$1 billion range, reflecting 2.2 per cent of the total PEF-driven acquisitions, while there was only one acquisition at or above US$1 billion, thus accounting for 1.1 per cent of the total PEF-driven acquisitions. In 2019, there were 16 acquisitions in the US$100 million to US$500 million range,

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4 Mergermarket, South Korea M&A activity, Q1–Q4 2018 trend report.
5 The figures for 2019 are based on data compiled in the first three quarters of 2019.
accounting for 24.2 per cent of the total PEF-driven acquisitions, and three acquisitions in
the US$500 million to US$1 billion range, reflecting 4.5 per cent of the total PEF-driven
acquisitions. 2019 also saw two acquisitions at or above the US$1 billion mark, thus
accounting for 3 per cent of the total PEF-driven acquisitions.

As for PEF-driven exits (excluding IPOs) in terms of transaction numbers in 2018,
there were 10 exits in the US$100 million to US$500 million range, accounting for
83.3 per cent of the total PEF-driven exits, and two exits at or above the US$1 billion mark,
accounting for 16.7 per cent of the total PEF-driven exits. In 2019, there were eight exits
in the US$100 million to US$500 million range, accounting for 34.8 per cent of the total
PEF-driven exits, one exit in the US$500 million to US$1 billion range, accounting for
4.3 per cent of the total PEF-driven exits, and one exit at or above the US$1 billion mark,
also accounting for 4.3 per cent of the total PEF-driven exits.

**PE fund acquisition trends**

Buyout and majority stake deals evidently increased 6.2 times in 2019 compared with 2018
in terms of deal value, and deal volume also increased from 28 to 52. On the other hand,
minority stake deals decreased compared with 2018. As a result, buyout and majority stake
deals accounted for 79 per cent of all acquisitions (in terms of transaction volume) and
88 per cent in terms of transaction value. Taking into account that the data for 2019 has yet
to be compiled, the increase of buyout and majority stake deals and the decrease of minority
stakes deals is a noteworthy change that took place in 2019.

<table>
<thead>
<tr>
<th>Year</th>
<th>Buyout (100%)</th>
<th>Majority stake (50% or more)</th>
<th>Minority stake (up to 50%)</th>
<th>Undisclosed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deal value (US$ billion)</td>
<td>Deal volume</td>
<td>Deal value (US$ billion)</td>
<td>Deal volume</td>
</tr>
<tr>
<td>2019</td>
<td>4.02</td>
<td>31</td>
<td>3.79</td>
<td>21</td>
</tr>
<tr>
<td>2018</td>
<td>-</td>
<td>-</td>
<td>1.26</td>
<td>28</td>
</tr>
<tr>
<td>2007</td>
<td>0.21</td>
<td>3</td>
<td>1.91</td>
<td>1</td>
</tr>
</tbody>
</table>

**PE fund exit trends**

Up until 2018, trade sales were the main exit channel for PEFs; however, secondary sale
exits became more common, and in 2019, there was roughly the same percentage of trade
sales and secondary sales (each around 45 per cent in terms of transaction value). As at
the third quarter of 2019, there was a relative increase of IPO exits compared with 2018;
however, IPO exits remained around 10 per cent of the total market in terms of transaction
value, and, therefore, do not constitute a significant exit channel compared to trade sales and
secondary sales.

<table>
<thead>
<tr>
<th>Year</th>
<th>Trade sales</th>
<th>Secondary sales</th>
<th>IPO</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deal value (US$ billion)</td>
<td>Deal volume</td>
<td>Deal value (US$ billion)</td>
</tr>
<tr>
<td>2019</td>
<td>1.92</td>
<td>12</td>
<td>1.94</td>
</tr>
<tr>
<td>2018</td>
<td>8.91</td>
<td>28</td>
<td>1.12</td>
</tr>
<tr>
<td>2007</td>
<td>3.07</td>
<td>11</td>
<td>1.24</td>
</tr>
</tbody>
</table>
**Trend of public-to-private transactions**

There were no public-to-private deals in 2018 and 2019, compared with the single public-to-private transaction worth US$0.36 billion in 2017. In general, public-to-private deals are not common in Korea, with only four public-to-private transactions recorded from 2007 to 2018.

**Registered private equity funds**

As at September 2019, a total of 676 PEFs were registered with the Financial Supervisory Service (FSS).6 In 2018, there was a significant increase to 198 newly registered PEFs, while there were only 93 newly registered PEFs in the first three quarters 2019. The total commitment amount increased from 74.5 trillion won in 2018 to 81.54 trillion won in 2019 (first three quarters of 2019).

<table>
<thead>
<tr>
<th>Year</th>
<th>2019</th>
<th>2018</th>
<th>2017</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newly registered PEFs</td>
<td>93</td>
<td>198</td>
<td>135</td>
<td>109</td>
<td>76</td>
</tr>
</tbody>
</table>

**Registered general partners of private equity funds**

As at December 2018, a total of 256 general partners (GPs) were registered with the FSS; among these, 170 are full-time GPs. The remaining 86 GPs are comprised of existing financial institutions, start-up investment companies and new technology companies. The number of GPs for newly established PEFs decreased from 19 in 2017 to 15 in 2018; on the other hand, the number of full-time GPs newly registered with the FSS increased from 23 in 2017 to 32 in 2018.

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2017</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full-time GPs</td>
<td>170</td>
<td>138</td>
<td>115</td>
<td>94</td>
</tr>
<tr>
<td>Financial institution GPs</td>
<td>37</td>
<td>35</td>
<td>41</td>
<td>41</td>
</tr>
<tr>
<td>Start-up GPs</td>
<td>49</td>
<td>36</td>
<td>34</td>
<td>32</td>
</tr>
<tr>
<td>Total GPs</td>
<td>256</td>
<td>209</td>
<td>190</td>
<td>167</td>
</tr>
<tr>
<td>Newly registered GPs</td>
<td>15</td>
<td>19</td>
<td>23</td>
<td>5</td>
</tr>
<tr>
<td>Newly registered full-time GPs</td>
<td>32</td>
<td>23</td>
<td>21</td>
<td>12</td>
</tr>
</tbody>
</table>

The largest private equity funds set up by major GPs in Korea in terms of committed capital are as follows: a 2,540 billion won fund set up by MBK Partners called MBK III; a 1,827 billion won fund set up by Hahn & Company called Hahn & Company III-1; and a 1,581 billion won fund set up by IMM Private Equity called IMM Rosegold IV.

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6 The vast majority of these were registered under the FSCMA, but the total number includes those registered under the Industrial Development Act and the Overseas Resources Development Business Act, Financial Supervisory Service, Status of Private Equity Funds in September 2019 (30 September 2019).
ii  Operation of the market

**Market standard management equity incentive arrangements**

There are certain precedents wherein a PEF with a controlling stake grants stock options or a small percentage of shares (either through transfer or issuance of new shares) to management with the aim of aligning the interests of the PEF with management; however, sophisticated forms of management equity incentive arrangements remain relatively uncommon in South Korea.

**Standard sales process**

As is the case in other jurisdictions, the investment process for private equity funds in South Korea usually takes place across the following stages: (1) deal structuring, (2) due diligence checks of investment target, (3) negotiation of deal terms, and (4) closing. To explain in further detail, in a standard share purchase transaction, the parties would first determine a due diligence cut-off date or valuation date, followed by the buyer conducting due diligence on the target. After due diligence, the parties would negotiate the terms and execute a share purchase agreement reflecting such terms. Subject to the fulfilment of conditions precedent to the closing date, the buyer would pay the purchase price to the seller and the seller would transfer its shares to the buyer. The final step usually involves a shareholders’ meeting or a board meeting to effect the replacement of the existing directors and officers of the target.

The overall process can take around six to seven months on average; however, this timeline can vary depending on the particular nature and complexity of each deal. If regulatory authorisations are required to complete the deal (e.g., because of foreign capital investment, industry-specific licensing requirements, or market dominance or competition-related issues), the process can be further delayed. Generally, the aforementioned regulatory authorisations are not especially onerous or far-reaching in terms of scope and depth of regulatory review, and, therefore, are not considered significant obstacles in most South Korean M&A deals.

II  LEGAL FRAMEWORK

i  Acquisition of control and minority interests

Pursuant to the FSCMA, Korean PEFs are required to either acquire de facto control over the target company or otherwise acquire a minimum of 10 per cent or more of the target company’s voting shares. Because of these regulatory restrictions, Korean PEFs must either engage in a buyout, acquire a majority stake in the target company, or otherwise acquire a minority stake of 10 per cent or higher. If a Korean PEF acquires a minority stake in a company, it can still influence the management or governance of the target company by means of a shareholders’ agreement with the controlling shareholder or major shareholders.

Unlike Korean PEFs, foreign PEFs are not subject to the aforementioned regulatory restrictions under the FSCMA, and thus Korean PEFs have been pressing for regulatory change to secure a level playing field between Korean PEFs and foreign PEFs.
**Fiduciary duties and liabilities**

The Korean Commercial Code does not impose fiduciary duties on a shareholder towards the company; furthermore, a shareholder is not liable for the debts of the company aside from the shareholder’s investment contribution. Therefore, a PEF (or its GP) shareholder does not owe any fiduciary duty towards the company and is not liable for the company’s debts beyond its investment contribution.

On the other hand, the KCC states that directors owe fiduciary duties towards the company and can be held both civilly and criminally liable for actions that result in harm to the company. These fiduciary duties and liabilities apply to all directors of the company, whether inside or outside directors, as well as to non-executive directors. Furthermore, individuals who do not officially hold director titles but nonetheless exert control over the company’s management can be treated as ‘de facto directors’ pursuant to the KCC and will be subject to the same fiduciary duties and liabilities as directors. It is common practice for personnel from a PEF investor to serve on the board of directors of a target company; therefore, by extension, the PEF director would also be subject to the aforementioned fiduciary duties and liabilities.

Another point of concern regarding fiduciary duties pertains to leveraged buyout transactions (LBOs); currently, there are differing opinions as to whether company directors can be held civilly and criminally liable for LBOs. The court precedents from the Korean judiciary distinguish between ‘collateralised LBOs’ and ‘merger LBOs’; in relation to the former, wherein the target company’s assets are used as collateral to obtain acquisition financing without giving any benefit to a target company, the Korean courts have ruled that the directors responsible are in criminal breach of their fiduciary duties. In contrast, with regard to merger-LBO scenarios, where the acquiring party sets up a special purpose company (SPC) and merges the target company with the SPC (thereby having the target company succeed to the liabilities of the SPC), the South Korean courts have not found criminal breach of fiduciary duties by the directors involved in debt push-down mergers of this type. Note, however, that these court rulings do not necessarily imply a bright-line rule with regard to criminal breach of fiduciary duties in an LBO context; for each transaction, the courts will decide based on the totality of circumstances (e.g., whether the LBO will enhance managerial efficiency, financial conditions and company value).

**III YEAR IN REVIEW**

**Recent deal activity**

The year 2019 saw a diverse range of M&A deals in South Korea in terms of deal size, ranging from small and medium-sized deals to mega deals worth US$1 billion and above. One mega-sized cross-border acquisition deal, Linde AG’s sale of Linde Korea to IMM Private Equity, had a deal value of approximately US$1.17 billion. Another significant cross-border deal is Hyundai Heavy Industries Holdings’ 17 per cent stake sale in Hyundai Oilbank to Saudi Arabian Oil for US$1.21 billion.

For noteworthy domestic M&A transactions, Korea Development Bank’s sale of Daewoo Shipbuilding & Marine Engineering to Korea Shipbuilding & Offshore Engineering
had a deal value of approximately US$4.5 billion. Other significant transactions include CJ ENM’s sale of its 50 per cent stake in CJ Hello to LG Uplus for a value of approximately US$1.26 billion, as well as Lotte Corporation’s sale of its 79.83 per cent stake in Lotte Card to the consortium of MBK Partners and Woori Bank for US$1.17 billion.

**Notable past transactions**

There have notable M&A deals led by PEFs in recent years, and PEFs have been involved in large M&A deals as a co-investor or a consortium partner.

In April 2019, IMM Private Equity acquired a 100 per cent stake in Linde Korea, with a deal value of approximately US$1.17 billion.

In February 2017, MBK Partners acquired a 100 per cent stake in DaeSung Industrial Gases, with a deal value of approximately US$1.5 billion.

In December 2016, the consortium of Hanhwa Life Insurance, Korea Investment & Securities, TongYang Life Insurance, Kiwoom Securities, Mirae Asset Global Investment, IMM Private Equity and Eugene Asset Management acquired a 29.7 per cent stake in Woori Bank, the fourth-largest commercial bank in Korea, with a deal value exceeding US$2 billion.

In September 2015, the consortium of Temasek Holdings, Canada Pension Plan Investment Board, MBK Partners, Public Sector Pension Investment Board and Chengdong Investment acquired a 100 per cent stake in Homeplus, a large hypermarket store chain, from Tesco, with a deal value of approximately US$6.4 billion.

**ii Financing**

As mentioned in Section II.ii, there is uncertainty over whether obtaining acquisition financing through LBOs constitutes a breach of directors’ fiduciary duty. Because of this restriction on LBOs, PEFs in South Korea tend to raise acquisition financing through loans from financial institutions. The amount and terms of such loans are determined based on the financial health and business operations of a target company. If a target company holds existing liabilities, it is market practice for PEFs to have the target company pay off the existing liabilities through refinancing from the financial institution simultaneously with the completion of the acquisition of the target company by PEFs. In large M&A deals, a syndicate of financial institutions provides loans often consisting of term loans and revolving facilities. Though it is not common, vendor financing has been provided in some M&A deals.

**iii Key terms of recent control transactions**

Before proceeding with a transaction, it is usual practice for PEFs to impose confidentiality obligations on the counterparties with regard to the transaction by way of a non-disclosure agreement. Such confidentiality obligations are particularly important with regard to publicly listed companies, since news of a potential acquisition may have a substantial effect on share prices and, by extension, result in a higher acquisition price. A related issue is that publicly listed companies may have limited capacity to enter into confidentiality obligations because of disclosure requirements; when faced with a disclosure request from the Korea Exchange, parties sometimes opt to disclose that a potential acquisition is being contemplated.

In acquisition transactions, certainty of closing and break-up (termination) flexibility are key concerns for PEFs, so they tend to request strict representations and warranties, indemnification obligations and material-adverse-change (MAC) clauses from the seller, while objecting to contractual language that undermines closing certainty or restricts their break-up flexibility. In recent years, insolvent companies have started to comprise a significant
portion of M&A targets in Korea; since sales and purchases of insolvent companies are supervised by the courts, the courts will sometimes impose various restrictions or conditions, such as purchase price adjustment restrictions and MAC clause prohibitions, from the onset of the bid process.

Furthermore, with the rising popularity of representations and warranties insurance, an increasing number of transaction documents include provisions to the effect that damages incurred as a result of a breach of representations and warranties shall be handled by the coverage amount of the relevant representations and warranties insurance policy.

With regard to purchase price adjustment mechanisms, the following options are available: (1) price adjustment based on net working capital, whereby the risk of value fluctuation between the valuation date and the closing date is borne by the seller; (2) the ‘locked-box’ method, whereby the risk of value fluctuation between the valuation date and the closing date is borne by the buyer; and (3) the earn-out method, whereby the buyer potentially pays an additional purchase price amount based on the target company’s earnings before interest, tax, depreciation and amortisation, business profits, net profits, cash flow, turnover, etc. In South Korea, it is common for parties to either opt for the locked-box method or forgo a purchase price adjustment mechanism altogether.

iv Exits
The joint sale of Oriental Brewery by KKR and Affinity Equity Partners with a deal value of approximately US$6.2 billion was both the largest and the most highly publicised exit by a PEF in Korea. The 2012 sale by Lone Star of its 51.02 per cent stake in Korea Exchange Bank with a deal value of approximately US$3.4 billion remains the second-largest private equity fund exit transaction in Korea. In 2019, KKR successfully exited by selling 100 per cent of its shares in KCF Technologies to SKC for approximately US$1.02 billion. In 2018, the Carlyle Group sold its 100 per cent stake in Siren Holdings, a company engaged in security solutions business through its subsidiary ADT Caps to the SK Telecom, Daishin PE and Keistone Partners consortium with a value of approximately US$2.7 billion. In 2017, Goldman Sachs and Bain Capital sold a 95.39 per cent stake in Carver Korea, a cosmetic manufacturer, to Unilever, with a value of approximately US$2.5 billion.

IV REGULATORY DEVELOPMENTS

i Regulatory landscape
Following the entry of foreign PEFs into the South Korean M&A market, the South Korean legislature went on to provide a legal framework for onshore private equity funds (Korean PEFs) by implementing the Indirect Investment Asset Management Business Act of 2004 and its successor, the FSCMA. The FSCMA requires all Korean PEFs to be registered with

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8 A potential downside of this option is that the parties have to come to an agreement on which accounts should be included to determine net working capital.

9 Under this option, the buyer will pay interest on the purchase price accumulated from the locked-box date up until the closing date, provided, however, that the transaction document clearly states that certain leakage from the target company is prohibited, and if leakage should occur, the buyer shall be indemnified accordingly.

10 The earn-out period is usually set at two to three years; a potential downside is that the buyer must continue to closely monitor the operations and earnings of the target company during this period.
South Korea

the FSS. Furthermore, as stated in Section II.i, Korean PEFs are required either to acquire de facto control over the target company or otherwise acquire a minimum of 10 per cent or more of the target company’s voting shares, whether directly or through an SPC.

There is no general legal framework that governs PEF M&A transactions; likewise, M&A transactions by PEFs are not subject to approval by a designated regulatory body. Nonetheless, each transaction can have differing regulatory requirements depending on the nature of the target company’s business and industry.

ii Recent regulatory measures
The government has recently taken certain regulatory measures that are expected to stimulate the M&A regulatory landscape in Korea. While these measures are still at the discussion stage, it is anticipated that reform of the PEF regulations and extension of the One-Shot Law discussed below will have a positive impact on the legal framework for PEFs, and will facilitate investment activity by PEFs within the Korean market.

Reform of PEF regulations
On 27 September 2018, the FSS announced its plans to reform the regulations governing PEFs and hedge funds. Specifically, the FSS is seeking to implement the following: (1) removal of the minimum 10 per cent stake rule that currently governs PEFs; (2) removal of the distinction between PEFs and hedge funds, and instead recategorising as general PEFs (PEFs that raise financing from retail, professional and institutional investors) and institutional PEFs (PEFs that raise financing exclusively from institutional investors), pursuant to which only institutional PEFs with the capacity to supervise their GPs will be permitted to make investments as limited partners; and (3) permitting PEFs to have up to 100 investors, an increase to the current limit of 49 investors.

Extension of One-Shot Law
Under the current laws, corporate restructuring requires the company to follow the procedures and authorisation requirements set out under the KCC. With the aim of facilitating corporate restructuring for companies in over-saturated industries, in August 2016 the Korean government announced the Special Act on Corporate Revitalization, colloquially known as the ‘One-Shot Law’. Under this One-Shot Law, a company whose corporate restructuring plan has been approved will be eligible for various benefits, including the simplification of the restructuring process, as well as tax incentives and financial support benefits. Amendments to the One-Shot Law (which extended the effective period of the One-Shot Law by another five years to August 2024 and expanded the applicability of the One Shot Law to companies in newly emerging industries and those located in industrial crisis areas) were passed by the National Assembly on 12 August 2019 and have been in effect since 13 November 2019.

The M&A landscape in 2020 will depend on the regulatory reform efforts of the South Korean government and geopolitical factors such as South Korea’s relationship with neighbouring countries and the denuclearisation of North Korea.
V OUTLOOK

After hitting historic peaks in 2014 and 2015, the South Korean M&A market has seen a temporary slowdown in the past few years; however, this downward trend is once again being reversed, with the South Korean M&A market continuing to show strong signs of recovery and continued growth. The combination of this upward trend with the government’s pro-M&A regulatory stance, various pre-emptive restructuring attempts by South Korean companies, and the ongoing development of PEFs means there is cautious optimism that the M&A market will continue to expand in 2020.

In terms of challenges in 2020, PEFs will have to grapple with the worsening economic situation in South Korea, as well as with competition from strategic investors. Minimum wage rises and shortened working hours are likely to have a negative impact on corporate bottom lines in 2020; furthermore, key industries such as the automobile and semiconductor sectors are showing signs of slowing down, while the global economic slump is also projected to impact South Korea’s M&A market in 2020. Nonetheless, there are various factors to offset these negative influences, including the pre-emptive restructuring of various South Korean companies and the improved regulatory landscape for PEFs. Furthermore, considering the financial constraints of corporate and strategic investors at this juncture, there is significant dealmaking potential for both Korean and foreign PEFs in 2020.
Chapter 17

UNITED STATES

Paul W Anderson

I OVERVIEW

i Deal activity

Although the buyout market remained healthy in 2019, competition from strategic buyers, higher public equity market valuations, uncertainty regarding tax and regulatory policy under the Trump administration and a worry over a global recession led to an overall decrease in both absolute transaction value and number of transactions compared with 2018.

Buyouts

Private equity sponsors completed 4 per cent fewer US buyout transactions in 2019 than in 2018, while the total amount invested fell by over 7 per cent. Despite this decline, private equity firms led a number of large buyouts, including Blackstone’s US$18.7 billion acquisition of US logistics assets from GLP, US$7.5 billion take-private of Merlin Entertainments and US$11 billion take-private of Ultimate Software; Goldman’s US$2.7 billion acquisition of Capital Vision Services; the US$5.4 billion take-private of Dun & Bradstreet by a consortium of investors, including CC Capital and Thomas H Lee; the US$6.5 billion take-private of Buckeye Partners LP by IFM Global Infrastructure Fund; Veritas Capital Fund and Elliott Management Corp’s US$5.5 billion take-private of Athenahealth; and the US$2.7 billion take-private of WestJet by Onex Corp. The 2019 market for private equity sponsor-led take-private transactions was roughly flat in terms of the number of deals, but the aggregate value of those deals jumped over 162 per cent compared with 2018 – driven, in large part, by the sizable take-privates mentioned above.

Growth equity

There was another year-on-year decrease in the number of US growth equity investments by private equity firms (i.e., purchasing a minority equity stake in a mature firm) in 2019, with the total number of deals down 12 per cent from 2018 levels. Aggregate reported value was also down meaningfully, dropping nearly 40 per cent compared with 2018.
Exits

Exit volume in 2019 continued to remain significantly below the 2014–2015 peak, with the value of 2019 exits falling to the lowest levels since 2012. Year-on-year exits were down nearly 17 per cent by number and just over 28 per cent by volume. Despite these weaker exit numbers, 2019 saw a continued increase in general partner (GP) led secondary offerings (i.e., secondary sales of limited partner (LP) interests in an existing fund) as buyout funds looked to both hold on to promising portfolio companies and provide LPs with a means of liquidity outside of traditional majority sales.

Despite the overall slowdown, there were several notable sales in 2019: Apax Partners, CPPIB and PSP Investments sold Acelity to 3M for US$6.7 billion and Blackstone announced the pending sale of Refinitiv to the London Stock Exchange for US$27 billion, including debt, just 10 months after acquiring Refinitiv from Thompson Reuters for US$20 billion.

Due, in part, to disappointing, high-profile listings by venture capital-backed companies such as Uber, Lyft and Pinterest, the failed WeWork initial public offering (IPO) and the January 2019 US government shutdown, the sponsor-led IPO market fell meaningfully from already depressed 2018 levels: just 23 private equity-backed companies went public in 2019. Notable 2019 private equity-backed IPOs included pet supplier Chewy (backed by BC Partners), chemical manufacturer Avantor (backed by New Mountain Capital) and direct-to-consumer dental company SmileDirectClub (backed by Clayton, Dubilier & Rice, Kleiner Perkins and Spark Capital).

In 2019, secondary portfolio company buyouts (i.e., sponsor-to-sponsor transactions) continued to grab an increasing share of the total number of M&A exits with more than half of all targets being sold to financial sponsors.

Looking ahead, the market for IPOs, corporate acquisitions and sponsor-to-sponsor buyouts will continue to be important for private equity firms looking to liquidate their inventory of portfolio companies, which continue to sit at an all-time high. In addition, the overall volume of GP-led secondary sales will increase as average holding periods trend higher and longer-term private investors (pension funds, family offices, sovereign wealth funds, etc.) continue to pursue direct investments alongside buyout funds.

Financing

The overall volume of US debt financing was down year-on-year, mirroring the overall decline in deal volume. According to Thomson Reuters, total US dollar-leveraged lending in 2019 fell over 31 per cent compared with 2018 levels (to just under US$900 billion). Lending to private equity sponsors for all purposes, including M&A, refinancing and dividend recaps, also experienced a sharp decline from 2018’s record numbers - falling nearly 37 per cent.

The 2019 buyout market also saw the first decline (albeit slight) in year-on-year leverage levels since 2015. The average debt multiple for larger broadly syndicated leveraged buyouts (LBOs) remained roughly flat at six times earnings before interest, tax, depreciation

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4 See footnote 2.
5 PitchBook data.
6 IPO Vital Signs data.
7 See footnote 2.
8 PitchBook data.
10 id.
and amortisation (EBITDA), while the average debt multiple for middle-market LBOs decreased from roughly 5.6 times EBITDA at the end of 2018 to 5.3 times EBITDA at the end of 2019.\textsuperscript{11}

**General partner investing**

2019 saw continued activity in the level of GP stakes investing, whereby private equity funds invest in the management companies of other sponsors. A record number of GP stakes investments closed in 2019, led by funds such as Dyal (a group within Neuberger Berman), AIMS (a group within Goldman Sachs) and Blackstone.\textsuperscript{12} These transactions give sponsors the ability to monetise a portion of their future management fees and carry without the trouble of publicly listing. Given the large funds raised to pursue GP stakes investing – over US$23 billion in 2019 alone (an increase of nearly four times 2016 levels) – a continued increase in activity is expected in this space in 2020.\textsuperscript{13} In fact, Dyal closed on its US$9 billion fund in the fourth quarter of 2019 (which is already 60 per cent invested) and is expected to begin fundraising for its next vehicle in 2020. In addition, new entrants to the space, including Aberdeen Standard Investments, Goodhart Partners and Stonyrock Capital Partners, are currently in the market raising new GP stakes funds.\textsuperscript{14}

**Fundraising**

Despite overall slower deal activity in 2019, fundraising by sponsors reached record levels, jumping 52 per cent from 2018 levels to over US$300 billion.\textsuperscript{15} 2019 also saw a growing market for ‘long-dated’ funds, with large players in the traditional sponsor market, such as Blackstone and Vista Equity Partners, looking to attract new capital to funds with investment horizons of 20 years or more.

**ii Operation of the market**

The US market for corporate control is very efficient. Many private targets are sold through an auction run by investment bankers or similar intermediaries. While a smaller proportion of public targets are sold through a full-blown auction, the legal framework (in general) attempts to duplicate an auction by encouraging a target’s board of directors to follow a process designed to secure the highest reasonably attainable price for stockholders.

**Public targets**

From a legal point of view, the US market for sponsor-led going-private transactions is driven primarily by the following considerations:

\begin{itemize}
  \item[a] the fiduciary obligations of the target’s board of directors, as defined by the laws of the target’s state of incorporation (most frequently, Delaware);
  \item[b] financing risks; and
  \item[c] the rules of the Securities and Exchange Commission (SEC) regarding tender offers or proxy solicitations.
\end{itemize}

\textsuperscript{11} id.
\textsuperscript{12} See footnote 2.
\textsuperscript{13} id.
\textsuperscript{14} id.
\textsuperscript{15} id.
Each of these factors influences not only the time required to purchase a US public target but also the transaction’s structure.

Delaware courts have held that when a target’s board decides to sell the company it must satisfy what are known as *Revlon* duties.\(^{16}\) *Revlon* requires a contextually specific application of the board’s normal duties of care and loyalty designed to ensure that it conducts a process to seek and attain the best value reasonably available to the target’s stockholders. There is no single, court-prescribed course of action for a board to follow (e.g., conducting a pre-signing auction for the target or always using a special committee of disinterested directors to negotiate with a suitor). However, certain conventions – such as fiduciary outs and limits on termination fees and other deal protections – have arisen in response to guidance from Delaware courts to balance the target board’s obligation under *Revlon* and the bidder’s desire to obtain deal certainty. For example, many deals feature a ‘go-shop’ exception to a target’s customary ‘no-shop’ covenant.\(^ {17}\) In a typical go-shop, the target is given a window – usually 25 to 40 days – to actively seek a superior offer. If a qualifying topping bid emerges during the go-shop period, the target may terminate its agreement with the original acquirer by paying a reduced termination fee and enter into a new agreement with the higher bidder. Most importantly, from a private equity bidder’s perspective, Delaware courts have concluded that a target board that does not conduct a pre-signing auction or market check can satisfy its *Revlon* duties by including a go-shop in the merger agreement, so long as the rest of the process and other deal protections are satisfactory.\(^ {18}\)

Parties to a US leveraged take-private must contend with the risk that debt financing may not be available at closing. Unlike in some other countries (e.g., the United Kingdom), ‘certain funds’ (i.e., a fully negotiated and executed credit agreement between a buyer and its lenders delivered at deal announcement) are neither required nor available in the United States, and financing commitment letters, no matter how ‘tight’ (i.e., lacking in preconditions), cannot be specifically enforced even if the providers of the letters have clearly breached their terms. In response, dealmakers have crafted a model that has become the most common (but by no means the sole) way to allocate the risk of financing failure.

This model generally allows a target to obtain, as its sole pre-termination remedy, an order from a court, known as an order for ‘specific performance’, forcing a buyer sponsor to make good on its commitment to provide the necessary equity financing and to complete the merger if, and only if, all the conditions to the merger are satisfied, the debt financing is available for closing and the target agrees to close when the equity is funded. If, on the other hand, the target chooses to terminate the merger agreement, either because the private equity

\(^ {16}\) *Revlon v. McAndrews & Forbes Holdings, Inc* (Del Sup Ct 1986). Many states do not follow *Revlon*; some states, such as Indiana (Indiana Code Section 23-1-35-1(d)), Pennsylvania (Pennsylvania Business Corporations Law Section 1715) and Wisconsin (Wisconsin Business Corporations Law Section 180.0827), have constituency statutes permitting directors to consider not only price, but also other stakeholders’ interests, such as the target’s employees, suppliers and communities in which the target operates, when considering a sale.

\(^ {17}\) A no-shop covenant prohibits the target from actively seeking an acquisition proposal, but typically allows a target to respond to an unsolicited proposal that could reasonably be expected to lead to a better transaction for target stockholders.

\(^ {18}\) See, e.g., *In re Topp’s C’Holder Litigation* (Del Ch 2007) and *In re Lear Corp C’Holder Litigation* (Del Ch 2007). There are many dimensions to a go-shop’s terms, such as the length of the go-shop period, the size of the reduced fee and limitations on what constitutes a superior offer, each of which is taken into account when evaluating the board’s compliance with *Revlon*. 
sponsor is unable to close because the necessary debt financing is not available or otherwise breaches the agreement, then the sponsor must pay the target a reverse break-up fee (usually an amount greater than the target’s termination fee) and the transaction is terminated. Payment of the reverse break-up fee is the target’s sole and exclusive remedy against the sponsor and its financing sources, even in the case of a wilful breach.¹⁹

Parties to a sponsor-led take-private transaction add yet another level of complexity when they choose to proceed via a two-step tender offer (rather than a one-step merger). In a tender offer, the sponsor offers to purchase the shares of the target directly from the stockholders, obviating the need – at least in the initial step – for a stockholder vote. The sponsor’s obligation to complete the tender offer is typically conditioned upon stockholders tendering more than 50 per cent of the outstanding shares. If this ‘minimum tender’ condition is satisfied, the sponsor must acquire all untendered shares in a ‘back-end’ merger, the terms of which are set out in a merger agreement executed by the target and buyer on the day they announce the tender offer. Depending on the circumstances of the deal, including the target’s state of incorporation, the back-end merger can be completed immediately after the closing of the tender offer; otherwise the buyer must engage in a long (three- to four-month) and expensive proxy solicitation process and hold a target stockholders’ meeting before it can complete the back-end merger.

Failure to acquire all the outstanding stock on the same day the tender offer closes makes it much more difficult to use debt financing because of the application of US margin stock rules, a highly complex set of laws and regulations that, in general, prohibit any person from financing the acquisition of US public company stock with more than 50 per cent debt financing secured by the target’s stock or assets. Many sponsor-led US take-private transactions are more than 50 per cent leveraged, so parties to such transactions must find solutions that satisfy the margin rules if they wish to enjoy the benefits of a tender offer.

The easiest way to avoid a delayed back-end merger is for the buyer to acquire in the tender offer a supermajority of the target’s shares – in Delaware, 90 per cent – allowing the buyer to complete a ‘short-form’ merger immediately after closing the tender offer. By completing the back-end merger essentially simultaneously with the offer, a sponsor can more easily structure its debt financing to comply with the margin rules and lender demands for a lien on the target’s assets. In most deals, however, it is not realistic to expect stockholders to tender such a large proportion of the outstanding shares.

Dealmakers address the potential delays of a full-blown back-end merger process and the complications presented by the margin rules largely by relying on a ‘top-up’ option or Delaware General Corporation Law Section 251(h).

**Top-up option**

In a top-up option the target agrees, upon completion of the tender offer, to issue to the buyer a sufficient number of its authorised but unissued shares to allow the buyer to reach the threshold required for a short-form, back-end merger. Delaware courts have approved the

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¹⁹ Not all deals follow this model. In some deals, sponsors have assumed all the financing risk and granted the target full specific performance; on the other, rarer end of the spectrum, buyers have agreed to a two-tiered reverse break-up fee, with a smaller fee payable if debt financing is unavailable, and a larger fee payable if the sponsor breaches its obligation to close (even if debt financing is available).
top-up option structure, with a few easily satisfied caveats, largely because it puts money in stockholders’ hands more quickly without harming their interests. The primary limitation of the top-up option is mathematical: the number of shares required to hit 90 per cent may be very large because the calculation is iterative, so it is often the case that a target does not have enough authorised but unissued shares in its constituent documents to utilise the top-up option.

**Section 251(h)**

Enacted by Delaware in August 2013, Section 251(h) eliminates, subject to certain conditions, the requirement for stockholder approval of a back-end merger after a tender offer for a listed company, or one with more than 2,000 stockholders of record, if the buyer acquires more than the number of shares required to approve a merger (typically a bare majority, but it could be more if the target’s certificate of incorporation so requires) but less than the 90 per cent threshold for a short-form merger.

Section 251(h) is an important and useful innovation, as it allows the buyer to acquire all the outstanding shares and the non-tendering stockholders to receive the merger consideration without the lost time and expense of a three to four-month proxy solicitation process. Furthermore, in June 2016, Delaware passed an amendment to Section 251(h) giving target management and other target stockholders the opportunity to exchange all or a portion of their target stock for buyer stock without running afoul of Section 251(h) rules, a limitation that had previously favoured the use of the top-up option in certain circumstances. As a result, the use of the top-up option, either in lieu of or as a backup in the event the Section 251(h) conditions cannot be satisfied, will continue to slow going forward.

**Deal litigation**

For many years, practitioners have accepted that stockholder lawsuits are simply part of the price of acquiring a public target, regardless of how well the target’s board managed the sale process. Prior to 2016, the vast majority of public company deals valued over US$100 million faced at least one shareholder lawsuit. These lawsuits, often filed within hours of a transaction’s public announcement, were frequently settled for the target’s promise to disclose additional information about the transaction process and the payment of a fee to the plaintiffs’ lawyers. However, key 2015 and 2016 cases saw Delaware courts sour on these ‘disclosure only’ settlements. In addition, recent case law has given additional clarity to deal process road maps that provide the target company with the ‘business judgement’ standard.

20 See Olson v. ev3, Inc (Del Ch 2011). The buyer must pay cash for at least the par value of the issued shares (with the remainder purchased with a demand note, the terms and conditions of which were approved by the target’s board), and the top-up option shares must be ignored if any dissenting stockholder elects to seek an appraisal of its shares.

21 In 2014, the Delaware legislature amended Section 251(h) to eliminate the ‘no interested stockholder’ condition in the original statute, which essentially prohibited acquirers from entering into support agreements with target stockholders, a common feature of private equity sponsor take-privates.


23 See, In re Riverbed Technology, Inc (Del Ch 2015); In re Aruba Networks, Inc Stockholder Litig, (Del Ch 2015); and In re Trulia, Inc Stockholder Litig, (Del Ch 2016).
of judicial review, a standard that makes it difficult for plaintiffs to prevail. While this trend has had the expected effect on the volume of nuisance lawsuits in Delaware, with public company merger litigation trending down over the past half-decade, there has been a partially offsetting increase in deal litigation in other states and federal courts as plaintiffs seek more favourable venues for claims.

During 2016 and 2017, as litigation focused on allegedly flawed sale process declined, plaintiffs shifted their focus to appraisal actions. Delaware General Corporation Law Section 262 permits stockholders of Delaware corporations to seek appraisal of his or her shares in lieu of accepting the merger consideration negotiated by the target and the acquirer. Historically, Delaware courts had given substantial weight to the merger price in determining the true ‘fair market value’ of a stockholder’s shares. Several 2016 Delaware cases saw judges lessen or eliminate their historical reliance on the merger price as evidence of value and instead focus on financial projections and related discounted cash flow analysis to come to their own independent calculation of fair market value for a target. These judicially derived values often varied substantially from the merger price. Interestingly enough, these 2016 cases suggested that Delaware courts were more apt to discount the deal price and give more weight to their own analysis in instances where the acquirer was a private equity sponsor. As a result, the plaintiffs’ bar rushed to file appraisal actions in 2016 and 2017, particularly where the acquirer was a private equity sponsor. The year 2017 ended, however, on a sour note for plaintiffs eager to have a Delaware judge second-guess deal consideration. Two key appraisal cases were overturned by the Delaware Supreme Court on appeal, including one with a private equity acquirer. The message in those cases was clear – Delaware courts should be deferential to the merger price unless there are sale process breakdowns that make the merger consideration suspect. Given the return to reliance on deal price as the primary indicator of value in appraisal actions, 2019 continued to see the volume of appraisal litigation in Delaware fall from 2016 and 2017 peak levels.

**Private targets**

Because it is easier to maintain confidentiality and the consequences of a failed auction are less dire, a full-blown auction for a US private target is more common than for a public target. In an auction for a US private target, the target’s advisers typically invite several bidders to conduct limited due diligence and submit indicative bids, with the highest and

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24 See, e.g., *Kahn v. M&F Worldwide Corp* (Del 2014); *Corwin v. KKR Financial Holdings LLC* (Del 2015); *Singh v. Attenborough* (Del 2016); *In re Solera Holdings, Inc Shareholder Litigation* (Del Ch 2017).


26 Stockholder must vote against merger; merger consideration is all or part cash (i.e., no appraisal rights where target stockholders are being paid solely in shares of an acquirer listed on a national securities exchange); before the vote on the merger, the stockholder delivers to target a written demand for appraisal of his or her shares; and within 120 days of the effective date of the merger, the stockholder commences an appraisal proceeding by filing a petition demanding a determination of the value of his or her shares.

27 See, *In re Appraisal of Dell Inc* (Del Ch 2016); *In re Appraisal of DFC Global Corp* (Del Ch 2016).

28 The court in *Dell* found the fair market value to be 28 per cent higher than the merger price, while the courts in *DFC* and *Farmers* found the fair market value to be 7 per cent and 11 per cent higher than the deal price, respectively.

29 See footnote 27.

most credible bidders invited to conduct further due diligence and submit additional bids. The time required to sell a private target can vary considerably: an auction and sale process for a desirable private target can take, from start to finish, as little as two months, while other processes may take many months. If the buyer requires debt financing, the health of the debt markets also affects the length of the process.31

In an auction, a private equity firm must compete not only on price but also on terms, timing and attractiveness to management. While in the past private equity bidders often conditioned their bids on receiving necessary debt financing, in today’s market such a condition is likely to affect the competitiveness of a bid adversely, particularly in a larger deal. Indeed, in the current market many private-target acquisition agreements (a clear majority in larger deals) contain the same conditional specific performance and reverse break fee mechanism now common in take-private transactions.

The US buyout market has also seen continued growth in the use of commercial insurance policies intended to protect buyers or sellers (or both) against various transaction-related risks, such as breaches of representations and warranties. These insurance products often allow parties to bypass difficult negotiation over post-closing indemnification by shifting specified transaction risks to a sophisticated third party in the business of taking such risks. An increasing number of private equity firms have successfully used M&A insurance to either make their bids more attractive to sellers or limit their post-closing liabilities when exiting an investment.

**Management equity**

Management equity practices vary across US private equity firms, but certain themes are common:

- Executives with sufficient net worth are expected to invest side-by-side with the sponsor to ensure they have sufficient ‘skin in the game’;
- Management equity entitles the holder only to modest stockholder rights – in some cases, only the right to be paid in connection with a distribution or liquidation;
- Holders of management equity get liquidity when and to the same extent that the sponsor gets liquidity; and
- Incentive equity (and at times part or all of management’s co-invested equity as well) is subject to vesting, whether upon passage of time, achievement of various performance goals, or a combination of the two.

The size of the management incentive equity pool generally ranges from 5 to 15 per cent, depending on the mix between time- and performance-based vesting, with smaller deals generally congregating at the upper end of the range, and larger deals generally at the lower end.

The prospect of participating in a potentially lucrative incentive equity pool can be powerful motivation for management to prefer a private equity buyer over a strategic buyer unlikely to offer a similar plan (and who might fire management instead). A private equity bidder for a private target can use this to its advantage, particularly when management cooperation is key to a successful sale. When pursuing a public target, however, such a

31 While in theory *Revlon* and related principles of Delaware law apply equally to the sale of a private target as to a public target, in practice a buyer often deals directly with target stockholders (or at least controlling stockholders), minimising or even eliminating the board of directors’ role and the related legal issues.

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strategy carries additional risk, as Delaware courts, the SEC and the market are sensitive to the conflict of interest presented when a target officer – particularly the CEO – has a personal incentive to prefer one bidder over another.

For this reason, the board of a public target often instructs its management not to enter into an agreement with a private equity suitor regarding compensation or equity participation before the stockholders have voted on the deal (or tendered their shares to the buyer). Indeed, it is often in a private equity buyer’s interest not enter into an agreement with management before the stockholder vote, because the SEC (by way of its Rule 13e-3) requires substantial additional disclosure in such situations. In addition, management participation in a transaction prior to a stockholder vote may increase the risk (and potentially cost) of stockholder lawsuits opposing the deal.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The US federal system – in which the federal (i.e., national) government exercises supreme authority over a limited range of issues, and the individual states exercise authority over everything else occurring within their respective jurisdictions, with overlaps seemingly everywhere – presents private equity firms with a complex legal maze to navigate when acquiring control of or investing in the equity of a target company. A private equity firm contemplating an investment in the United States confronts the following regulatory regimes:

a federal securities laws and regulations, administered by the SEC;
b state corporation law (usually the Delaware General Corporation Law), alternative business entity law (usually the Delaware Limited Liability Company Act or the Delaware Limited Partnership Act) and securities laws (called ‘blue-sky’ laws);
c federal, state, local and foreign tax laws and regulations;32
d Hart-Scott Rodino Antitrust Improvements Act (the HSR Act) pre-merger antitrust review;
e particularly when making a minority investment in a public target, the rules of the stock exchange where the target’s shares are listed, such as the New York Stock Exchange or the Nasdaq National Market;
f potential review by the Committee on Foreign Investment in the United States of an investment by a non-US investor in a US target, if the investment threatens to impair national security; and
g industry-specific regulatory schemes – such as those found in the energy, pharmaceutical, medical device and telecommunication industries – that may require advance notification to or even approval by a governmental authority.

The first three regulatory schemes – federal securities laws, state corporate and securities laws, and tax – affect every investment a private equity firm may make in the United States. The HSR Act applies only if a deal exceeds specified levels,33 and the applicability of the others depends on the nature of the target and, in some cases, the characteristics of the buyer as well.

32 The tax implications of any private equity transaction are tremendously complex. For a thorough discussion of the issues, see generally Ginsburg, Levin and Rocap (footnote 45).
In general, neither US federal securities laws and regulations nor Delaware corporate and other business entity laws focus upon the substance of a transaction. Rather, the federal scheme is designed to ensure that parties to the transaction – whether a direct sale of stock, a merger, a tender offer or issuance of shares – receive adequate disclosure, and in some cases adequate time to make a fully informed investment decision, and Delaware law is chiefly concerned with the process followed by the company’s governing body when considering the transaction, except in the case of interested transactions, which are subject to entire-fairness review (looking at both process and price).

Regulatory schemes outside Delaware law and US federal securities laws and regulations, however, often do look at the substance of transactions and can be influenced by political movements. For example, deal practitioners have seen increased difficulty in getting clearance for transactions with Chinese and other foreign acquirers under the Trump administration. The Trump administration has also taken a firmer stance on antitrust review of transactions – a development that took many by surprise.

ii Fiduciary duties and liabilities

Corporations

In general, stockholders of a Delaware corporation do not owe any duty, fiduciary or otherwise, to one another. Thus, a private equity firm is free to act in its own interest, subject to very limited exceptions, when deciding to vote or sell its portfolio company stock, subject to contractual rights (e.g., tag-along or registration rights) of the company’s other stockholders. On the other hand, a controlling stockholder may be liable to the corporation or its minority stockholders if the controlling stockholder enters into a self-interested transaction with the corporation at the expense of the minority.

All directors (and officers) of a Delaware corporation, including sponsor representatives on the board, owe the corporation and its stockholders the following duties:

- a duty of care, requiring a director to be reasonably informed and to exercise the level of care of an ordinarily prudent person in similar circumstances;
- a duty of loyalty, requiring a director to act in the interests of the corporation and its stockholders and not in his or her own interest; and
- a duty of good faith, or perhaps better stated a duty not to act in bad faith, often described as the intentional or reckless failure to act in the face of a known duty, or demonstrating a conscious disregard for one’s duties.

Subject to limited exceptions, when reviewing the conduct of a corporation’s directors Delaware courts will apply what is known as the ‘business judgement rule’, which presumes that a director acted with reasonable care, on an informed basis, in good faith and in the best interest of stockholders, and not second-guess the director’s decisions. Only if a plaintiff proves that a director made an uninformed decision or approved a self-interested transaction will the courts apply the ‘entire fairness’ doctrine and require the director to prove that the price and the process leading to the disputed transaction were fair to the corporation and

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35 id.
36 This section deals only with the laws of Delaware. The laws of other states may be materially different.
37 See, e.g., Abraham v. Emerson Radio Corp (Del Ch 2006).
38 See, e.g., In re Loral Space and Communications Inc (Del Ch 2008).
its stockholders. In addition, when reviewing certain transactions, such as the imposition of defensive measures (e.g., a poison pill) or the sale of control in the absence of a ‘fully informed’ disinterested shareholder vote39 (see the Revlon discussion in Section I.ii), Delaware courts apply what has come to be known as ‘enhanced scrutiny’, a standard more rigorous than the business judgement rule but less than entire fairness, in which the court reviews the adequacy of the process leading to the challenged transaction and whether the price was reasonable.

Delaware law also allows a corporation to exculpate its directors (but not officers) from monetary liability for a breach of the duty of care,40 and to indemnify its directors and officers against claims and expenses arising out of the performance of their board duties.41 Such exculpation and indemnification are not available, however, for any director or officer found to have breached the duty of loyalty.

A sponsor representative on the board of a Delaware corporation must also be aware of the corporate opportunity doctrine, under which a corporate officer or director must offer the corporation any business opportunity that the corporation is financially able to undertake, that is within the corporation’s line of business, and with respect to which the corporation has an interest. The corporate opportunity doctrine can cause a problem for a sponsor owning or expecting to invest in a competing or similar business, but it can be disclaimed if appropriate language is included in a company’s articles of incorporation.

If a Delaware corporation has preferred and common stock, its board owes its duties only to the common stockholders if there is conflict between their interests and those of the preferred stockholders.42 If a corporation is insolvent (or in bankruptcy), then the board’s fiduciary duties are owed to the corporation’s creditors, not its stockholders.43 If a financially struggling corporation is in a grey area known as the ‘zone of insolvency’, then its directors have a duty to maximise the enterprise value of the corporation for the benefit of all those with an interest in it.44

**Limited liability companies**

Recently, private equity firms have begun to prefer Delaware limited liability companies (LLCs) over corporations when structuring an investment. Delaware law allows sponsors and their co-investors to craft custom LLC governance provisions, including the total elimination of voting rights and fiduciary duties (other than the contractual duty of good faith and fair dealing),45 which streamline decision-making and avoid potential personal liability of sponsor board representatives. The added flexibility of an LLC is both a benefit and a burden, as Delaware courts have consistently held that any modification to traditional corporate principles must be clearly and unambiguously stated in the LLC’s operating agreement; otherwise, traditional corporate principles will apply (perhaps in unexpected ways).

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39 See, e.g., Corwin v. KKR Financial Holdings LLC (Del Ch 2015); City of Miami Employees’ and Sanitation Employees’ Retirement Trust v. Comstock (Del Ch 2016).
40 Delaware General Corporation Law Section 102(b)(7).
41 Delaware General Corporation Law Section 145.
42 In re Trados (Del Ch 2013).
43 Geyer v. Ingersoll (Del Ch 1992).
44 North American Catholic Educational Programming Foundation, Inc v. Gheewalla (Del Sup Ct 2007).
45 See Ginsburg, Levin and Rocap, Mergers, Acquisitions, and Buyouts – Transactional Analysis (Wolters Kluwer, September 2015), Section 1602.3.
Using an LLC, which is treated like a partnership for tax purposes (unless an election is filed with the Internal Revenue Service to be taxed as a corporation), eliminates corporate-level tax and thus can also be more tax-efficient for certain investors – although the reduction in the corporate-level tax rate and other changes implemented as a result of the Tax Cuts and Jobs Act passed in December of 2017 has made that benefit less certain. Non-US investors who are not US taxpayers, however, must exercise caution when investing in an LLC, as they may be obligated to file a US tax return and pay US income tax on their US effectively connected income.

III DEBT FINANCING

The huge US market for acquisition debt financing is highly sophisticated and efficient, with many experienced investors and service providers and multiple options for a private equity sponsor seeking to finance an acquisition.

No two deals are the same, and the availability of certain types of debt financing depends on market conditions, but US LBO financing structures typically fit into one of the following categories:

- senior and bridge loans, with the bridge loan usually backstopping a high-yield bond offering, typically used in very large deals;
- first-lien and second-lien loans, typically used in upper-middle-market deals, with the availability and pricing of second-lien debt highly dependent on market conditions;
- senior and mezzanine loans, typically used in middle-market deals;
- unitranche loans, which combine senior and mezzanine features into a single blended loan, typically used in middle-market deals; and
- senior loans only, typically only used in smaller deals or deals in which the private equity sponsor is using very little leverage.

Except for smaller deals (US$100 million or less), most lending facilities are arranged by a financial institution and then syndicated to other lenders, including banks, hedge funds and special purpose entities – known as collateralised loan obligations – created to invest in these loans.

Because UK-style certain-funds debt financing is not available in the United States, the parties to an LBO – the lenders, the private equity sponsor and even the target – inevitably face market risk between execution of the acquisition agreement and closing. Those parties, particularly the sponsor, must therefore carefully manage that risk in the agreements, especially in the interplay among the debt and equity financing commitment letters and the acquisition agreement.

The non-pricing terms (i.e., excluding items such as fees, interest rates and original issue discounts) of an LBO loan – such as affirmative, negative and financial covenants, collateral requirements and defaults – vary considerably from one deal to the next, based on the size of the transaction and the perceived creditworthiness of the borrower. In general,

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46 The ‘marketing period’ for a syndicated loan, during which the institution arranging the loan assembles the lending syndicate, typical runs for between three and four weeks.

47 See discussion in Section I.

48 Many middle-market and most – if not all – larger loans are rated by credit rating agencies such as S&P and Moody’s.
however, loans for smaller deals are more similar to one another with respect to affirmative, negative and financial covenant requirements. Non-pricing terms for larger loans occupy a wide spectrum ranging from a full covenant package to ‘covenant-lite’ loans. In a syndicated loan, key terms, including pricing and debt structure, are typically subject to some limited changes in favour of the lenders – referred to as ‘flex’ – in the event that the loan cannot be syndicated in the absence of these changes (which may not include, however, additional conditions precedent to funding).

IV OUTLOOK

US private equity investors are cautiously optimistic over 2020’s prospects. Although a phase one trade deal with China, the continued abundance of dry powder and low interest rates provide some tailwinds for US private equity going into 2020, concerns remain: a looming presidential election, protectionist trade policies in the United States and abroad, disruption in the public equity markets, high valuations for acquisition targets and the prospect of increases to interest rates, could all lead to economic disruptions and dampen private equity investment activity. On the other hand, US private equity firms have proved their ability to thrive in changing and challenging times, with many posting solid returns in the midst of the Great Recession, others successfully managing the difficult process of leadership change and the industry as a whole adapting to an entirely new regulatory and tax regime.
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Andrew has been involved in high-profile private equity transactions, having acted for Baring Private Equity Asia Pte Ltd in the sale of an approximately 73.8 per cent stake in Courts Asia to Nojima Asia Pacific Pte Ltd, and E-Shang Infinity Cayman Limited and InfinitySub Pte Ltd in the acquisition of shares in Sabana Investment Partners Pte Ltd and units of Sabana Shari’ah Compliant Industrial Real Estate Investment Trust. He also advised Ascendas Hospitality Trust in the combination with Ascott Residence Trust by way of a trust scheme of arrangement to form the largest hospitality trust in the Asia-Pacific region and the eighth biggest globally, with a total asset value of S$7.6 billion.

Andrew graduated from the University of Nottingham and is admitted as a barrister-at-law (Gray’s Inn) and to the Singapore Bar.

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Lorna is a frequent speaker on major industry conferences and forums on topics such as private equity market trends, private equity fund structuring, co-investments, private equity transactions and due diligence. She is also a respected instructor and faculty member for various training courses.

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Mr Cvak holds law degrees from the University of Vienna and New York University Law School (LLM), and he has attended extracurricular classes on private equity, corporate finance, investment banking and accounting at the New York University Stern School of Business.

Mr Cvak is ranked by international legal directories such as *Chambers Global, Chambers Europe, The Legal 500, IFLR1000* and *Who’s Who Legal*. He was named Austrian private equity
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Mr Cvak is admitted to the Austrian and New York Bars. He regularly authors articles on private equity, M&A, corporate finance and restructuring in major international and national publications, and he is a frequent speaker at conferences and seminars on private equity and corporate and M&A matters.

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Vera Figueiredo has expertise in advising companies and groups in restructuring operations, both domestic and cross-border, and covering all phases from feasibility analysis to planning and implementing the operations. She also has expertise in advising clients in tax structuring their investments in Portugal, namely in real estate and other sectors.

Mrs Vera Figueiredo also has extensive experience in international tax transactions and has advised clients on inbound and outbound investments and on the internationalisation of several Portuguese groups, as well as advising multinationals investing in Portugal.
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Mr Goebel is a Mexican lawyer specialising in mergers and acquisitions, private equity, capital markets, and banking and finance.

He is recognised as a leading lawyer and for his outstanding expertise by Chambers Latin America, IFLR1000, Best Lawyers and PLC Which lawyer? Chambers Latin America ranks him as a leading individual for capital markets, describing him as a ‘tremendous negotiator’, and also notes that ‘he is a very good and innovative lawyer who offers strong capabilities in financing matters’. Other recent editorial commentary in this publication includes feedback from clients who point out that Mr Goebel is ‘a terrific lawyer who is always on top of everything and can resolve anything you ask of him’, and they highlight his ‘rare skill in being able to capture what is important, and being truly practical in making it happen’.

Mr Goebel spent a year working in the Chicago office of international law firm Mayer Brown, having received his LLM (with honours) from the Northwestern University Pritzker School of Law of Chicago. He graduated as an attorney from the Autonomous Technological Institute of Mexico and has lectured in financial contracts at the Ibero-American University. He has acted as an independent director and board secretary for various financial and non-financial institutions.

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Mr González specialises in banking and finance, structured finance, mergers and acquisitions and private equity.

He has experience in advising public and private companies on issuances in the local market and abroad, and in advising foreign companies, investment funds, banks and brokerage firms on matters primarily related to banking and securities law, capital markets, private equity investment structures, and compliance and supervision of the Mexican securities market.

Mr González graduated as an attorney-at-law (2009) from the Panamerican University, from which he also holds a graduate degree in commercial and corporate law, with honours (2010), and he obtained his LLM in finance from the Institute for Law and Finance of the Goethe University Frankfurt am Main (2013); he is a candidate for an MBA at the Monterrey Institute of Technology and Higher Education.
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Marco Graziani is a tax lawyer with extensive experience in all areas of taxation. He is actively involved in the structuring of sophisticated M&A, private equity, financing, restructuring and real estate deals, as well as in the designing of complex financial instruments. He regularly supports domestic and international clients in the establishment of European and Italian fund structures and in dealing with all related issues, from the setting-up of managing and advisory entities to the structuring of efficient carried interest schemes, and he assists several non-Italian institutional investors and sovereign funds in optimising their Italian investment structures. He has a successful track record in efficiently managing relationships with the tax authorities, as well as in the context of the fund industry, from negotiating rulings and advance pricing agreements to representing clients in tax audits, settlements and appeals.

EKTA GUPTA

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Ekta Gupta is an M&A and PE partner at the firm and has advised multiple blue-chip private equity funds, public and private companies, sovereign wealth funds, multinational corporations, strategic corporate clients and Indian conglomerates on a wide variety of their complex cross-border PE and M&A transactions. Ekta’s diverse practice includes representing clients in acquisitions, disposals, minority and strategic investments, and advising on strategic joint ventures. In 2017, she was recognised as the 11th most hardworking corporate lawyer in Asia by Mergermarket based on the number of deals she closed in 2017, in terms of volume. In 2018, she was shortlisted as a Rising Star in Asia for corporate matters in the Euromoney Legal Media Group Asia Women in Business Law Awards 2018.

Ekta Gupta’s notable transactions include advising Walmart in relation to its investment by Walmart International Holdings, Inc and Walmart Inc in acquiring a 77 per cent stake in Flipkart Pvt Ltd for an aggregate consideration of US$16 billion. This is currently the largest e-commerce acquisition in the world. In another transaction, she advised One97 Communications Limited (Paytm) in relation to a multi-staged investment of US$680 million by Alipay Singapore E-Commerce Private Limited and Alibaba Inc, which won Deal of the Year at the IFLR Asia Awards 2015.

She has also advised Blackstone in relation to the 100 per cent buyout of two seaplane operating companies in the Maldives, which was nominated for the private equity Deal of the Year at the IFLR Asia Awards 2014.

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Jonathan assists asset managers in their dealings with Canadian regulators and counsels them on acquisitions, joint ventures and mergers.

Before joining Fasken, Jonathan practised with a leading UK law firm in its investment funds group.
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He has been distinguished as a leading corporate/M&A lawyer by Chambers, Asialaw Profiles, The Legal 500 and Legal Times.

He has acted for reputable private equity houses, including IMM, H&Q, Mirae Asset PE and Skylake, as well as strategic investors such as SK Group, Lotte Group, Hanwha Group, OCI, FILA and Novelis.

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She has been recognised as a leading lawyer in the banking and finance arena by *Chambers Global* and *Chambers Asia-Pacific* since 2009. In the *Chambers* publications, she is recommended for being ‘sharp and articulate’ and is described as someone whose ‘effective negotiating style’ has earned her ‘particular plaudits’. She is also commended as ‘someone you would always want to have on your side’ and praised for her ‘skills and proficiency’, ‘whose strong grasp of securities, acquisitions and debt restructurings makes her a lawyer of choice for a number of major private equity houses and investment banks’ with an ability to ‘highlight key commercial points for clients’. Known for her ability to ‘handle the counsel on the other side very well, so that a reasonable outcome can be struck’, she has earned praise for having ‘proven to be a tough yet practical negotiator for her clients and never fails to exceed expectations’.

Appreciative clients have also commended her for being a practitioner who is able to ‘come to an agreement with the other side of the table to effectively resolve issues without compromising our position’ and also asserted that they ‘would recommend her’ and declared her to be a ‘very tough lawyer’. She is also identified as a leading practitioner in various other publications – *IFLR1000* in financial and corporate law, *The Legal 500: Asia Pacific, Asialaw Profiles, Who’s Who Legal: Banking and Best Lawyers.*
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André Luiz Gomes has extensive experience in corporate finance, capital markets and M&A. In recent years, he has advised public and private institutions on the acquisition of companies, on capital markets (public offerings and takeovers) and on the structuring of private equity transactions. He has advised clients on matters in a variety of different sectors (particularly banking and financial intermediation services), as well as in the private equity sector, notably in relation to restructuring funds and transactions of companies in this context.

He has also been deeply involved in bank recapitalisation transactions (in the context of the recapitalisation of the Portuguese banking system).

Mr André Luiz Gomes is recommended by several leading legal directories, including *Chambers Global*, *Chambers Europe* and *PLC Which lawyer?*, for his work in corporate and M&A, capital markets and private equity.

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Frank Mausen specialises in securities law and capital markets regulation, including stock exchange listings. His clients include banks as well as corporate, institutional, supranational and sovereign issuers, which he advises on debt and equity transactions and structured finance transactions, including securitisation, structured products, covered bonds, IPOs, placements and buy-backs of securities, exchange offers, listing applications and ongoing obligations deriving from such listings.

Frank regularly holds conferences on securitisation and other capital markets topics in Luxembourg and abroad. He is a member of the securitisation working group of the Association of the Luxembourg Fund Industry and the securitisation working group and the Securities Committee of the Luxembourg Bankers’ Association. Frank is also a member of the Islamic Finance working group of Luxembourg for Finance (Luxembourg’s agency for the development of the Luxembourg financial centre) and is a member of the securitisation working group of the HCPF (an advisory committee set up by the Luxembourg Ministry of Finance, aiming to modernise Luxembourg’s financial sector legislation).

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Raghubir won the M&A Lawyer of the Year: Private Equity for Asia Pacific at the Asian Lawyer Emerging Markets Awards 2015 for the work undertaken over 2015. As ‘one of the few lawyers that has the combination of both commercial and legal skills’, Raghubir Menon enjoys a formidable reputation in the private equity market. ‘He would always be available and meet the deadlines without compromising on quality. We were more than impressed,’ explains one client, as quoted by *Chambers*.

Prior to joining Shardul Amarchand Mangaldas, Raghubir worked with White & Case LLP, in London and Singapore, for five years. Raghubir has an LLB from the prestigious National Law School of India University, Bangalore. He enrolled at the Bar Council of Delhi in 2004 and is a qualified solicitor (England and Wales).
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Patrick regularly speaks about and publishes articles on tax topics. He is a member of the Tax Committee of Invest Europe, of the board of the Luxembourg Private Equity Association and of the Tax Steering Committee within the Association of the Luxembourg Fund Industry.

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Anil Motwani is an associate in the Asia investment funds practice at Shearman & Sterling.

Anil represents fund sponsors in all major asset classes and regularly advises clients in the design, restructuring and documentation of alternative investment products. He also advises private equity fund sponsors and investors on ongoing operational matters.

The clients Anil represents include Chinese, Indian and multinational firms. He also advises major institutional investors on their investments in private funds around the globe. Anil has extensive experience representing limited partners and general partners in their fund transactions.

Anil is qualified in New York. He has a JD from Columbia University Law School and a BA from the University of Southern California.

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Sean Murphy is counsel in the Asia investment funds practice at Shearman & Sterling.

He has a decade of experience advising private investment fund managers and investors from Hong Kong, Singapore and New York.

Sean regularly advises private equity, growth capital, real estate, infrastructure, credit and hedge fund sponsors, as well as sovereign wealth funds, asset managers and other investors, on all aspects of their businesses, including fund structuring and formation, capital raising and marketing, acquisition and disposition of portfolio investments and fund governance and carry arrangements. He is also experienced in advising clients on M&A and joint venture transactions.

Sean has been invited to instruct on training courses organised by leading organisations such as the Hong Kong Venture Capital and Private Equity Association.
He has a JD (with honours) from the George Washington University and a BA (*magna cum laude*) from the University of Pennsylvania and is qualified in New York.

Sean is a native English speaker and is proficient in Mandarin Chinese.

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Peter Myners is the co-head of Allen & Overy’s global alternative investment sector group. His practice consists of a wide range of corporate matters, and he has notable expertise in mergers and acquisitions (both domestic and cross-border) and joint ventures and co-investments. In particular, Peter has extensive experience in advising global alternative investment managers on the establishment and ongoing operation of their Luxembourg investment platforms, as well as on the deals they execute from those platforms.

Peter is a member of the Executive Committee of the Luxembourg Private Equity and Venture Capital Association, and a regular speaker at seminars in Luxembourg and the surrounding area on a broad range of topics, including on trends in the alternative investments space, M&A trends, recent developments in Luxembourg corporate law and directors’ duties under Luxembourg law.

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Andrés is a partner at Von Wobeser, with more than 19 years of professional experience in Mexico, New York and Latin America advising large multinationals and global private equity investors and sponsors on acquisitions and investments in Mexico across multiple industries. His clients appear in Fortune 50 and Fortune 500, as well as the Dow Jones, NASDAQ, S&P 500, DAX and the Nikkei. He has a multidisciplinary practice, with an emphasis on cross-border transactions, which includes experience in several of the principal transactions that have taken place in Mexico and the United States in the legal areas of private equity, banking and finance, fintech, securities, project finance and anti-money laundering, as well as mergers and acquisitions. Furthermore, Andrés has become a prominent figure with regard to fintech in Mexico. Additionally, he has advised clients in the development of legal strategies and solutions in relation to, among other areas, cross-border acquisitions, financial operations and bank investments, incorporation of companies and associations, workouts, restructurings and reorganisations. He has been recognised by *Chambers Latin America, The Legal 500, Latin Lawyer 250, IFLR1000* and *Best Lawyers*, among others. Andrés actively promotes both pro bono and diversity causes.

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Mariana Norton dos Reis has been a partner in Cuatrecasas’ corporate M&A group since 2010. She worked at the Madrid office from 2004 to 2017 and is currently based in the Lisbon office, where she started her career in 1998.

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She regularly acts for private equity investors on their investments and divestments, and represents strategic investors in connection with cross-border acquisitions and sales of privately owned companies and assets. She has recently completed a number of major transactions in the infrastructure, energy, retail, real estate and financial industry sectors in Spain and Portugal.

On an international level, she has extensive experience in advising on M&A transactions for multinational companies in Europe, Latin America and the United States.

In March 2015, Expansión, a Spanish business and finance newspaper, named her one of the most active lawyers in M&A in Spain based on the number of deals closed in 2014. In 2017 and 2018, Iberian Lawyer included Mariana in its InspiraLaW list of top 50 women in the legal sector and, in 2013, Mariana received the same publication’s ‘40 under Forty Award’.

Mariana obtained her Bachelor of Laws from the University of Lisbon School of Law (1997) and her Master of Laws (LLM) in advanced corporate law and securities from Columbia Law School, New York (1998). She was also named a Harlan Fiske Stone Scholar of Columbia Law School (1998) and received a scholarship from the Luso-American Development Foundation.

Mariana lectured on the master’s degree in business law in cross-border mergers at the Autonomous University of Madrid and on the bachelor’s of law degree in business administration and management at CEU San Pablo University, Madrid. She is the founder and coordinator of the Women in Business programme at Cuatrecasas and a member of the Women Lawyers’ Interest Group Committee of the International Bar Association.

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Fi Ling has acted for private equity firms in both public and private M&A transactions. The more recent public M&A transactions include acting for Yanlord Land Group Limited in relation to the mandatory general offer for United Engineers Limited, Baring Private Equity Asia Pte Ltd in the sale of an approximately 73.8 per cent stake in Courts Asia to Nojima Asia Pacific Pte Ltd and China Everbright Limited in the mandatory unconditional cash offer for Ying Li International Real Estate Limited.
In the private M&A space, she has acted for OUE Limited in the sale of Oakwood Premier OUE Singapore, its luxury serviced residences and hotel business to a joint venture between AMTD Group and hotel operator Dorsett Hospitality International, and KKR, as Singapore counsel, in its acquisition of Arnott's and certain of Campbell's International operations.

Fi Ling is recognised for her corporate and M&A expertise by *Chambers Asia-Pacific* and is also a recommended lawyer in *The Legal 500: Asia Pacific* for corporate and M&A in Singapore. She is recognised as a notable practitioner in M&A and private equity by *IFLR1000*.

Fi Ling graduated from the National University of Singapore and is admitted to the Singapore Bar.

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*Fasken Martineau DuMoulin LLP*

Anabel Quessy’s corporate law practice focuses on serving the investment management industry. As part of the investment management practice team, Anabel regularly counsels asset and fund managers in connection with compliance with applicable securities laws and regulations and assists them in setting up new investment funds, including alternative asset management structures (notably private equity, venture capital, infrastructure and lending). Anabel also accompanies clients through mergers and acquisitions of investment management businesses, helping clients at all stages of the process, from the initial deal structuring to the post-closing integration of assets.

Anabel also advises institutional investors on corporate issues and the governing regulatory framework.

**RYAN RABINOVITCH**  
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Ryan Rabinovitch is a partner in the tax group. Ryan’s practice deals with all aspects of tax law, with a particular focus on tax planning and tax litigation.

Over the years, Ryan has held a variety of positions in the legal profession, from which he has gained broad expertise. He worked as a comparative law clerk for Aharon Barak, the then President of the Supreme Court of Israel, and served as law clerk to the Honourable Louise Arbour, then a justice of the Supreme Court of Canada.

Before joining Fasken, Ryan practised with an international law firm.

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Deepa Rekha is a principal associate with the general corporate, M&A and PE practice group at the firm. She primarily works on matters pertaining to private equity, fund formation and mergers and acquisitions and has represented clients such as Blackstone, Temasek, Rabobank and KKR. Her major deals include assisting Blackstone’s investment in IBS Software Services Private Limited and KKR’s investment in Bharti Infratel Limited.
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Stephen L. Ritchie is a partner in the Chicago office of Kirkland & Ellis. His practice is concentrated in the areas of complex business transactions, with a particular focus on structuring, negotiating and managing the legal aspects of mergers, acquisitions, leveraged buyouts, recapitalisations, venture capital and growth equity investments, restructurings and workouts. He has also served as lead counsel in the representation of numerous portfolio companies of private equity funds.

Praised by clients for achieving ‘remarkable results on divestitures’ and by peers as ‘one of those great lawyers who is easy to work with’, Mr Ritchie has been recognised by Chambers USA: America’s Leading Lawyers for Business in the areas of corporate law, M&A and private equity every year from 2006 to 2019. He was also named Best Lawyers’ 2013 Chicago leveraged buyouts and private equity law Lawyer of the Year. He has also been listed in The Best Lawyers in America every year from 2007 to 2019, and as one of Illinois’ Super Lawyers every year from 2005 to 2006, and 2008 to 2019. He has been recognised by The Legal 500: United States, from 2012 to 2020, for his work in private equity buyouts.

Mr Ritchie has handled many private equity, leveraged buyout, venture capital and M&A transactions for GTCR, TCV, CHS Capital, Chicago Growth Partners, Evergreen Pacific Partners, William Blair Capital Partners, Wind Point Partners, the Ontario Teachers’ Pension Plan Board, Solera Holdings, Inc, and others.

He is a lecturer at the University of Chicago Law School, teaching ‘Private Equity Transactions: Issues and Documentation’ (from 2011 to the present), and is a member of the American Bar Association.

BRANDON RYU
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Myong-Hyon (Brandon) Ryu’s practice focuses on mergers and acquisitions with a particular emphasis on cross-border (both inbound and outbound) transactions. He also has extensive experience in private equity transactions, joint ventures, corporate restructurings and corporate governance. Mr Ryu has represented both major Korean and foreign industrial and financial companies, as well as private equity firms.

Mr Ryu devotes a portion of his practice to advising clients in anti-corruption (including anti-corruption due diligence in M&A transactions), Foreign Corrupt Practices Act-related and internal investigations, transnational white-collar crime defences and other compliance matters.

Mr Ryu has been distinguished as a leading corporate/M&A lawyers by Chambers Global, Chambers Asia-Pacific, The Legal 500, IFLR1000, Asialaw Profiles and PLC Which lawyer? He was commended in The Legal 500: Asia Pacific for ‘always trying to find the right solutions and exceed clients’ expectations in all respects’. He is also described by Chambers Asia-Pacific as ‘a very bright and pragmatic team leader who is involved in many of the firm’s most prominent recent deals’ and someone who ‘understands the corporate world very well and tries to make things as straightforward as possible’. He is a regular contributor to various international journals, as well as a speaker at international and domestic conferences covering the areas of his expertise. He has been interviewed and quoted by newspapers and magazines for his knowledge and expertise in M&A.
Mr Ryu received a JD from Vanderbilt University Law School in 2001 and a BA, magna cum laude, from Sogang University in 1998. He is a member of the New York Bar.

Mr Ryu has co-authored articles for international publications, including International Financial Law Review and Asian Counsel. He has also lectured at the Judicial Research & Training Institute, Sungkyunkwan University and Konkuk University.

ISY ISAAC SAKKAL
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Isy Isaac Sakkal works as an associate in the Geneva office and is a member of the banking and finance group. His main areas of practice include banking and finance, commercial and contractual matters. Mr Sakkal is admitted to the Bar in Geneva and New York. He completed his law studies at the University of Geneva and obtained an LLM degree from the University of California, Berkeley in 2017.

BORYS D SAWICKI
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Borys D Sawicki joined Soltyński Kawecki & Szelązak in 1998 and specialises in banking and finance transactions, focusing on project finance and other structured financings. His area of expertise also includes leveraged finance and securitisation transactions. For several years, he has worked closely with the European Investment Bank and the European Bank for Reconstruction and Development, providing advice in the fields of project finance, local self-government regulations, public aid and public procurement laws. In the field of corporate law, he has successfully completed a number of mergers and acquisitions of entities of various sectors and provides day-to-day corporate advice to numerous clients.

KEVIN P SCANLAN
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Kevin P Scanlan is a partner in the New York City office of Kramer Levin Naftalis & Frankel LLP.

He advises clients on structuring, forming and investing in international and domestic private investment funds, including hedge funds, private equity funds, real estate funds, venture capital funds and funds of funds. In addition, Kevin advises funds in connection with their subsequent investment activities. He represents large, well-established funds and managers as well as first-time funds of high-quality emerging managers.

He gained an LLM in taxation from the New York University School of Law (2000), a JD from Fordham University School of Law (1997) and a BA, cum laude, in classics and economics from Fordham University (1993), and was admitted to the New York Bar in 1999.

He is a member of the Managed Funds Association Outside Counsel Forum, the New York Hedge Fund Roundtable and the New York State Bar Association Private Investment Funds Subcommittee, and is a faculty professor at the Regulatory Compliance Association’s CCO University.
ENZO SCHIAVELLO
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Enzo Schiavello has a solid background in M&A and corporate law. For more than 20 years, he has been active in the structuring and establishment of alternative investment schemes for domestic and international clients, with particular emphasis on private equity and real estate funds. His expertise ranges from the formation and restructuring of licensed investment managers to the setting up of corporate and contractual structures in Italy and other EU jurisdictions, including funds of funds, co-investment funds, infrastructure funds, non-performing loan funds, SICAFs, structured products providing exposure to private equity as an underlying asset class, and various arrangements for the distribution of carried interest among managers. He also assists clients with respect to fund restructurings and other general partner-led transactions.

CLEMENS PHILIPP SCHINDLER
Schindler Attorneys

Clemens Philipp Schindler is a founding partner of Schindler Attorneys. Before establishing the firm, he spent six years as a partner at Wolf Theiss after practising with Haarmann Hemmelrath in Munich and Vienna, and with Wachtell Lipton Rosen & Katz in New York. His track record includes some of the largest and most prestigious Austrian and Austria-related transactions, such as the initial investment of América Móvil into Telekom Austria or Infineon's sale of its wireless business to Intel, as well as many private equity deals for international funds such as ARES, ARDIAN, Apax, DBAG, EQT, HIG, Internos, Kennet, Melrose, MDP, OpCapita, Riverside, Sankaty, Triton and TVM Capital.

Mr Schindler's practice focuses on corporate and tax law advice in relation to public and private M&A, private equity and corporate reorganisations (including mergers, spin-offs and migrations), most of which have a cross-border element. Furthermore, Clemens is specialised in international holding structures. His practice is complemented by private client work (e.g., as counsel to families owning stakes in large companies).

Mr Schindler is ranked by leading international legal directories, including Chambers Global, Chambers Europe, The Legal 500, IFLR1000 and Who's Who Legal. The German legal directory JUVE singles him out as one of Austria's top 20 corporate and M&A lawyers, while the Austrian business journal Trend named him among the country's top 10 corporate law experts. In addition to the listings for the Austrian market, both Chambers Global and Chambers Europe acknowledge his Brazilian expertise in a special ranking.

Mr Schindler is admitted in Austria both as an attorney-at-law and a certified public tax adviser, holding law degrees from the University of Vienna and New York University (LLM in international taxation) as well as a degree in business administration from the Vienna University of Economics and Business Administration. He has authored and co-authored more than 50 articles, books and commentaries in his fields of expertise, where he is also a much sought-after speaker at conferences and seminars.
TAE-YONG SEO
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Mr Tae-Yong Seo is a partner at Shin & Kim. Mr Seo’s main areas of practice include international and domestic securities offerings, mergers and acquisitions of financial institutions, corporate restructuring and general corporate transactions. Mr Seo also worked previously as a foreign associate in the Hong Kong office of Simpson Thacher & Bartlett LLP and has experience in capital market transactions.

DONG IL SHIN
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Mr Dong Il Shin is an associate at Shin & Kim. He received his JD from Seoul National University and a BA, summa cum laude, from Seoul National University. Mr Shin joined Shin & Kim in 2019 and specialises in M&A transactions and corporate governance.

CATARINA CORREIA DA SILVA
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Catarina Correia da Silva has extensive experience in M&A and private equity transactions. The main projects on which she has been advising recently include the structuring and negotiation of sale and purchase agreements, the coordination of due diligence procedures, and the negotiation of finance agreements, commercial contracts and partnerships in a wide variety of sectors, as well as the structuring of private equity transactions.

Mrs Catarina Correia da Silva provides legal advice on setting up private equity funds and distressed debt funds, and provides day-to-day assistance regarding the legal framework of private equity funds and of their management entities.

TARANJEET SINGH
Shardul Amarchand Mangaldas & Co
Taranjeet Singh is a principal associate with the general corporate, M&A and PE practice group at Shardul Amarchand Mangaldas & Co. He primarily works on matters pertaining to private equity, mergers and acquisitions, and portfolio investments by funds. He has advised many private equity and sovereign wealth funds across the full range of their operations and has represented clients such as Blackstone, Temasek, General Atlantic, Inventus, KKR and Urbaser. His notable transactions include advising Blackstone in relation to the 100 per cent buyout of two seaplane operating companies in the Maldives, which was nominated for the private equity Deal of the Year at the IFLR Asia Awards 2014; advising Blackstone in relation to the acquisition of a controlling stakes in Agile Electric Supply Private Limited, and in Mphasis Limited; advising Temasek in relation to its investments in UST Global, Devyani International Limited, Zomato and CarTrade; and advising General Atlantic in relation to its investment in Krishna Institute of Medical Sciences Limited.

Taranjeet also successfully completed a client-secondment stint with Blackstone Group’s Asia-Pacific legal and compliance team, with direct reporting to the group’s general counsel for India.
MARCELO SIQUEIRA  
_Campos Mello Advogados in cooperation with DLA Piper_

Marcelo Siqueira is a senior associate in the tax area at Campos Mello Advogados, having joined the firm in 2015. He graduated with a BA in law from the Pontifical Catholic University of Rio de Janeiro in 2002, obtained a _lato sensu_ postgraduate qualification (LLM) in corporate law and capital markets law from the Brazilian Institute of Capital Markets in 2005, a _lato sensu_ postgraduate qualification in tax law from the Brazilian Institute of Tax Studies in 2008 and a _stricto sensu_ postgraduate qualification (master's degree _cum laude_ ) in international law from the State University of Rio de Janeiro in 2012. He has an extensive practice in the areas of tax consultancy and planning, with special emphasis on foreign investment, day-to-day operations, intellectual property taxation and M&A.

JEAN-CHRISTIAN SIX  
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Jean-Christian Six has extensive expertise advising clients in relation to the structuring, establishment and ongoing operation of Luxembourg regulated funds (UCITS, Part II funds, SIFs and SICARs) and Luxembourg unregulated funds (limited partnerships and RAIFs) for institutional and non-institutional investors active across all asset classes, including alternative assets such as private equity, real estate, infrastructure and debt/credit. He also assists management companies and AIFMs on their licence applications and extensions, and on cross-border issues. Jean-Christian also advises clients in the context of their investor due diligence on, and negotiations with, investment funds, as well as advising funds on their transactions and regulatory issues.

Jean-Christian regularly speaks at conferences on Luxembourg fund-related topics. He is a member of the Association of the Luxembourg Fund Industry, including acting as co-chairman of its infrastructure funds working group.

CHRIS CHANG-HYUN SONG  
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Dr Chang-Hyun Song is a partner in Shin & Kim's corporate/M&A group. His main areas of practice include M&A, private equity and corporate governance. As a member of leading law firms in South Korea and in the United States, Dr Song has undertaken major M&A projects in the fields of banking, securities, insurance, telecommunications, information technology, games, automotive parts, energy, chemistry, paper manufacturing and shipbuilding. Based on considerable field and academic experience, his expertise extends to various other legal areas, such as overseas direct investment, capital markets and securities.

Dr Song received a Doctor of Juridical Science degree in corporate and financial law from the University of California, Berkeley, School of Law, and currently teaches M&A and corporate law at Yonsei University and the Seoul Bar Association. Dr Song also publishes various legal articles and periodic columns on corporate, competition and finance law, and he is an active participant in several academic societies and conferences.
SHUHEI UCHIDA
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Shuhei Uchida is a partner at Mori Hamada Matsumoto. His practice ranges from advising on high-profile M&A transactions to general corporate matters and M&A-related disputes. He is well-known for his expertise in corporate law based on his experience working on the draft of the amended Companies Act that became effective in May 2015, which substantially changed M&A practice in Japan through the introduction of a new structure for squeeze-outs of minority shareholders.

ADALBERTO VALADEZ
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Mr Valadez specialises in taxation matters and concentrates his practice on federal income tax and international tax matters, including cross-border M&A and joint ventures, inbound investments into Mexico, and the structuring and implementation of collective investment vehicles (such as private equity funds) managed by Mexican and foreign sponsors.

He is recognised as a leading lawyer and for his outstanding expertise by Chambers Latin America, IFLR1000, Best Lawyers, The Legal 500 and Latin Lawyer 250. Chambers Latin America ranks him as a leading individual for tax, and mentions a client describing him as ‘the best tax adviser for financial markets’ and adding that ‘his service is extraordinary; he responds immediately and is always available’.

He has solid experience in advising clients on issuances in the local securities market, particularly in the case of capital development certificates and exchange-traded funds. As part of this practice, he regularly advises multinational clients that are either making investments in Mexico or have commercial relationships with companies in Mexico.

Mr Valadez graduated with honours as an attorney from the Autonomous Technological Institute of Mexico and he also previously worked as a foreign associate in the Amsterdam, Luxembourg and Geneva offices of Loyens & Loeff.

IRIS WANG
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Iris Wang is an associate in the Asia investment funds practice in Shearman & Sterling’s Hong Kong office.

Iris works on transactions for both general partners and limited partners in Asia. She helps private equity and hedge fund sponsors on asset management and funds-related matters and has accumulated an extensive understanding on fund structuring and regulatory issues related to fund managers.

She is qualified in New York and the China. She graduated from Shanghai Jiao Tong University, KoGuan Law School, as an outstanding graduate and received an LLM degree from New York University School of Law.
JAMES YONG WANG
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James Wang has 19 years of experience in the investment funds and private equity/venture capital field. He has represented international and Chinese fund clients in the structuring of approximately 1,500 domestic and offshore PE, VC, hedge, real estate, mezzanine, film and media, energy and infrastructure funds, qualified foreign limited partner (QFLP) and renminbi-qualified foreign limited partner funds, qualified domestic limited partnership (QDLP) and qualified domestic investment enterprise funds, qualified foreign institutional investor and renminbi-qualified foreign institutional investor funds, and qualified domestic institutional investor funds with total capital commitments in excess of the equivalent of US$50 billion. He also regularly represents clients in joint venture and partnership transactions, private equity/venture capital and M&A and capital markets transactions in and outside China. He has been consistently ranked as a leading lawyer in investment funds, private equity and venture capital for China by Chambers, Who’s Who Legal, The Legal 500, IFLR1000 and Legalband. He was also named a market leader for investment funds in China by the London-based Legal Media Group’s global Expert Guides for banking, finance and transactional law, from 2015 to 2020 (the only lawyer with a PRC law firm named by Expert Guides in the investment funds category in China). He is a member of the expert review committee of the QFLP and QDLP pilot programmes administered by Shanghai Financial Services Office, and also served as adviser to the committee on private equity secondary market initiatives. James is also active in private equity and venture capital investments, M&A and capital markets transactions. Prior to working for Jingtian & Gongcheng, James worked at several major international law firms in the United States and China, including Clifford Chance, Kirkland & Ellis, Greenberg Traurig and the PRC law firm of Han Kun. James is a CFA and CAIA charterholder.

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David Widger is a partner and head of A&L Goodbody’s corporate department. His key areas of expertise include mergers and acquisitions, corporate finance, private equity, venture capital, corporate restructurings, and capital markets and securities law. Mr Widger's practice involves advising a wide range of Irish and international public and private corporations, institutions and private equity funds on all legal aspects of their corporate affairs.

Mr Widger’s knowledge of the law and expertise in dealing with complex issues is consistently recognised by clients and peers in leading international publications, including Chambers Global, Chambers Europe, The Legal 500, Best Lawyers, IFLR1000, PLC Which lawyer? and Who’s Who Legal.

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Maxi Wilkowski is a certified German lawyer. She joined PwC in 2006. Her professional focus is on regulatory and legal aspects of the financial services industry. Maxi is specialised in advising firms entering the German market on applicable regulatory licensing and notification procedures.
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Rongjing Zhao is a partner in the Shanghai office of Kirkland & Ellis International LLP. She focuses her practice on the representation of public and private companies, as well as private equity firms, in a variety of complex cross-border transactions, including private placement and pre-IPO financing, mergers and acquisitions (inbound and outbound), leveraged buyouts and joint ventures. Her experience also includes advising private equity firms and institutional investors in the formation, governance and acquisition of investment funds.

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Adele Zito graduated with honours from the LUISS Guido Carli University in Rome in 2013. In 2012, she spent a semester at the Aarhus University School of Business and Social Sciences in Denmark. She began her professional career at BonelliErede in 2013, dealing with corporate law, commercial law and financial markets. In 2015, she obtained her LLM in international business law at the Sorbonne-Assas International Law School in Paris. Since then, her practice has focused on out-of-court activities such as extraordinary transactions, with particular regard to the equity capital markets, mergers and acquisitions, and operations sectors.
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