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The eighth edition of The Private Equity Review follows an extremely active 2018. While the number of global private equity deals completed declined from 2017, the total value of such deals was the highest since 2007, and the third-highest of all time. Deal activity was weighted towards the upper end of the market, and included several large take-private transactions. Fundraising activity was also strong, as institutional investors remained extremely interested in private equity as an asset class because of its strong performance relative to public markets. As a result, private equity funds have significant amounts of available capital, leading 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 all of this, 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, a slowing Chinese economy, Brexit and an eventual end to one of the longest-running recoveries in US history – on the horizon for 2019 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. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 25 different countries, with observations and advice on private equity deal-making 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 eighth 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  
April 2019
Chapter 1

**AUSTRIA**

*Martin Abram and Clemens Philipp Schindler*

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**I GENERAL OVERVIEW**

At the time of writing, no information was available about the fundraising market in 2018 or 2017. The most recent information available is for 2015, for which the Austrian Venture Capital Association reported that Austrian private equity and venture capital funds raised €111 million, a significant increase over the fundraising in 2014 (below €20 million) and 2013 (around €20 million). However, most of this fundraising activity was related to one single fund focusing on early-stage investments.

The number and volume of Austrian private equity and venture capital funds continues to be well below the European average. Except for the one early-stage fund, there is no noticeable activity in the market.

Following general elections, a new Austrian government took office in December 2017 and announced its intention to implement a programme for an overall strategy for private equity, and for the creation of a competitive legal framework for venture capital and private equity funds. However, aside from a minor amendment lowering certain entry barriers for private investors in private-equity umbrella or venture capital funds, no other implementation measures had been announced at the time of writing.

**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 alternative investment funds (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.

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 minimum capital 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 an ELTIF (see below), 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 will cease 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:

- investment restrictions, such as target size, concentration limits, geographic limitations, diversification of industries, limits on borrowing and related-party transaction restrictions;
- limitations on the fund’s size and the investors’ capital commitments;
- investment period;
- key-man provisions;
- provisions permitting the removal of the manager by a qualified majority of investors;
- remuneration of the manager (i.e., management fee, investment-related fees and carried interest);
- reinvestments; and
- 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 Market Act has to be used. In this case, additional disclosure requirements apply.

**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 below); 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 a European long-term investment fund (ELTIF) (see below); 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 (see below); 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 of a prospectus by the FMA, or both, 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 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 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 (see above). Additionally, the designation of an AIF as an ELTIF allows its marketing to high-net-worth individuals throughout the EU.

The ELTIF Regulation is not compulsory; if an AIFM does not want to use the ELTIF designation, then 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 apply, such as national private placement regimes.

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.

As mentioned above, 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**

As mentioned above, 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.

For partnerships structured with no individual (but only a corporation) as general partner, as is usually the case, equity contributions had generally been subject to capital duty at a rate of 1 per cent. The same was true for fund vehicles structured as corporations until 1 January 2016, when capital duty ceased to be levied. Another area to consider is stamp duty, in particular in relation to guarantees that the formation documentation may entail. 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 (as of 1 January 2016); and dividends are subject to withholding tax at a rate of 27.5 per cent (as of 1 January 2016).

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). As of 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 as of 1 January 2016) 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 OECD 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 (as of 1 January 2016). 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 Austrian government will make good on its announcement of its intention to implement an overall strategy for private equity and for the creation of a competitive legal framework for venture capital and private equity funds.

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Chapter 2

BRAZIL

Marcus Vinicius Bitencourt, Alex Jorge, Renata Amorim, Marcelo Siqueira and Tatiana Pasqualette

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.

According to recent studies carried out by the Brazilian Private Equity and Venture Capital Association (ABVCAP) between 2011 and 2017,2 the interest of local and international investors in the Brazilian private equity industry has dramatically risen over the past few years, especially in 2015 when the total committed capital reached US$38.1 billion.3

Despite the reduction in fundraising volume in 2016 caused by the economic and political crisis, 2017 was a notable year for the private equity industry in Brazil. Investments in that sector increased 34.5 per cent over 2016 and fundraising reached the amount of US$1.3 billion4 in that year, 90.8 per cent of this being in foreign currency and 9.2 per cent in Brazilian reais.5 There was also a record of divestment deals: 55 companies have been

1 Marcus Vinicius Bitencourt and Alex Jorge are partners, Renata Amorim and Marcelo Siqueira are senior associates and Tatiana Pasqualette is an associate at Campos Mello Advogados in cooperation with DLA Piper.
3 Conversion from Brazilian reais into US dollars is according to the exchange rate announced by the Brazilian Central Bank on 31 December 2018.
4 These monetary values have been converted from Brazilian reais to US dollars at the exchange rate for 31 December 2018, as published by the Brazilian Central Bank.
5 See footnote 2.
subject to divestments,\(^6\) in a total amount of US$2.6 billion,\(^7\) which, according to private equity specialists, is linked to the end of the investment cycle of funds started between 2011 and 2013.\(^8\)

In 2018, the political uncertainty kept investors more cautious to commit capital in Brazil as a natural consequence of the presidential election. The volume of private equity transactions occurred in that year represented only a gentle increase of 6 per cent from 2017, according to the data disclosed by Transactional Track Record (TTR).\(^9\)

One of the most remarkable deals held in 2018 was the acquisition of a majority stake of 80 per cent by the global private equity fund Advent International in Walmart Brazil Group, the third-largest food retailer in Brazil.\(^10\) Advent International also has other significant investments in Brazil, which includes other leading retail companies such as Lojas Quero-Quero and Restoque/Dudalina.

Other standout investments were those performed by Aqua Capital, a Brazilian management of private equity funds focusing on growth investments in mid-market companies throughout the Brazilian and South American agribusiness. Over 2018, they invested approximately US$100 million\(^11\) in six companies, most of them engaged in the distribution of commodities.\(^12\)

Despite the slow performance of the Brazilian market in 2018, and especially the small increase in the volume of private equity transactions (compared to the 2017 volume), as mentioned above, the venture capital industry recorded an impressive expansion. According to the data disclosed by TTR,\(^13\) venture capital transactions represented a trade volume of approximately US$1.6 billion in that year.

This upward trend is directly related to the development of Brazilian start-up companies that have been attracting local and foreign investors, especially in the technology segment. Over the past year, certain Brazilian companies have been consolidated as ‘unicorns’ (private start-up companies with US$1 billion valuations or higher), such as 99, Pagseguro, Nubank, Arco Educação and Stone.\(^14\)

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 (which are out of the corporate chain of the investing company). The main purpose of the CVC investment is the development, by the well-established institutions, of a new product or a specific market instead of establishing

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\(^{6}\) Ibid.

\(^{7}\) See footnote 4.

\(^{8}\) See footnote 2.


\(^{11}\) See footnote 4.


an internal department of project and development (P&D), since the P&D strategy may prove to be more time- and cost-consuming and demanding than the investment in an early-stage company.\footnote{CVC investments go beyond a customary merger and acquisition transaction, although the process and the documentation involved may often be similar. In CVC transactions, the investing company and the target company have to establish some 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.}

An example of a CVC transaction held in 2018 in Brazil was the investment made by Santander InnoVentures, the fintech venture capital fund of Santander Group, in Creditas (leading Brazilian secured lending platform).\footnote{Available at \url{www.santander.com/csgs/Satellite/CFWCSancomQP01/en_GB/Corporate/Press-room/Santander-News/2018/04/17/Santander-InnoVentures-makes-its-first-investment-in-Brazil-via-digital-lending-platform-Creditas.html}. Accessed on 10 January 2019.} Other Brazilian companies, from various sectors of the economy, such as Embraer SA (the Brazilian business conglomerate that manufactures commercial and military aircrafts, among others), banks (BB, BMG, Itaú), industry (Gerdau, Natura, Votorantim) and retail (Pão de Açúcar, Magazine Luiza), also invest in early-stage companies for purposes of generating business innovation.

Finally, for 2019, specialists forecast that after a period of recession caused by political uncertainty and economic crisis, the Brazilian market will start a steady turnaround. The political rupture marked by the election of the right-wing President Jair Bolsonaro represents an important step for the recovery of the Brazilian economy.

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 until November 2018\footnote{Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais. Ranking de Gestão de Fundos de Investimento, November 2018. Available at \url{www.anbima.com.br/pt_br/informar/ranking/fundos-de-investimento/gestores.htm}. Accessed on 10 January 2019.} were BB DTVM SA, Itaú Unibanco SA and Bradesco.

\section{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.

\subsection{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.\(^{18}\)

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 closed-ended (i.e., it does not allow for the redemption of its shares, except in the event of liquidation of the fund), and directs its funds to the purchase of shares, subscription warrants, non-convertible debentures,\(^{19}\) 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, 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, so the terms of the Brazilian Law of Corporations (Law No. 6,404/76, as amended) are not applicable to them. They are instead subject to the terms of the Civil Code and specific rules issued by the CVM. Hence, the FIP is an asset held by a pool of owners, where the owners hold a portion (shares) of the total assets.

It is important to mention that on 30 August 2016 a new CVM instruction, CVM Instruction No. 578/16, was enacted, replacing CVM Instruction No. 391/03 and creating new rules concerning the formation, operation and management of FIPs. Furthermore, on the same date, CVM Instruction No. 579/16 was issued creating new rules for the provision of financial statements of FIPs, outlining the accounting methods for the classification of assets and liabilities.

As regards the funds 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 an 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:

\(\text{a} \quad \text{the FIP’s portfolio management;}

\(^{18}\) 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; or does not allow access to information related to shareholding, ownership of assets or rights or to the economic transactions performed. The standard tax rate of 20 per cent to identify privileged tax regimes is reduced to 17 per cent if the country and its privileged tax regime follows the international standards of tax transparency (Ordinance MF 488/14), as established by the Brazilian Federal Tax Authorities (RFB).

\(^{19}\) An important development introduced by CVM Instruction No. 578/16 is that FIPs can now invest in non-convertible debentures, up to the limit of 33 per cent of the total subscribed capital of the fund, except for Infrastructure FIPs (FIP-IE) and Intensive Economic Production in Research Development and Innovation FIPs (FIP-PD&I), which can invest in debentures that are convertible or non-convertible into shares.
b investment advising;
c treasury activities;
d assets processing control activities;
e placement of shares;
f bookkeeping of issuance and redemption of shares;
g custody of financial assets; and
h market maker for the FIP’s shares.

It is also worth mentioning that CVM Instruction No. 578/16 establishes that, 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 addition, without prejudice to the above-mentioned, 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.

It is also worth mentioning that CVM Instruction No. 558/15, which came into force on 4 January 2016, as amended by CVM Instruction Nos. 593/17 and 597/18, has introduced new rules on the activities related to securities portfolio 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:

a 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
**b.** 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. 592/17.24

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:

- **a.** one or more officers (authorised by the CVM) responsible for the management activities;
- **b.** 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
- **c.** 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.

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

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24 CVM Instruction No. 592/17 was enacted on 17 November 2017.
organised market management entities where the FIP’s shares are placed, any material act or
cfact 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:

- 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.);

- 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; \(^{25}\)

- 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. \(^{26}\)

### 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), and 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:

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

- 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;

- to fulfil the provisions of the fund’s by-laws or the agreement executed with the client,
  which must contain the following 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;
  - 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;

\(^{25}\) The information mentioned in this item (b) shall be sent to the CVM based on the fiscal year of the FIP.

\(^{26}\) As regards item (c) above, it is important to mention that 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 on CVM Instruction No. 391/03 (revoked by CVM Instruction No. 578/16), and has increased
from 120 to 150 days the term for the provision of the audited financial statements.
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;

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;\textsuperscript{27}

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;

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;

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

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.

The 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.

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 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 definition of 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

\textsuperscript{27} 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) above.
access market, and which ensures, contractually, corporate governance standards stricter than those required by law, provided that the investment corresponds to up to 35 per cent\(^2\) 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 prohibition on issuing founders’ shares, with measures taken to ensure the absence of securities of this type in the market;
- 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;
- 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;
- to resolve corporate disputes through arbitration;
- in the event that the investee company goes public through category A,\(^{29}\) 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
- an annual audit of its financial statements by an independent auditor registered with the CVM.

iv  FIP portfolios

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

- seed capital;
- emerging companies;
- infrastructure (FIP-IE);
- intensive economic production in research development and innovation (FIP-PD&I); and
- multi-strategy.

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28 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.

29 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.
Each category of FIP as described above is allowed its own investment policy, subject to
the applicable rules established by the CVM. Seed capital and emerging company FIPs, for
instance, are now 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 above), 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, and 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 is that
all FIPs can now 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. 578/16.30

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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30 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.
Brazil

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 payment 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&Is 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 quota holders, 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

d) the advanced funds are converted into capital increase of the invested company within 12 months.

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31 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.

32 Pursuant to Section 1 of Article 17 of CVM Instruction No. 578/16, the new projects are considered those implemented after 22 January 2007.
v 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 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.

33 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.

34 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’. 
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. 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, acceptance, 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 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)\(^\text{37}\) 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.

### 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 an FIP depends on previous registration with the CVM, which shall be automatically granted upon delivery of the following documents and information:

1. incorporation documents and the full text of the by-laws, with a certificate proving its registration with a registry of instruments and documents;

\(^{37}\) 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.
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, and that the agreements are available to the CVM;

d a statement specifying the name of the independent auditor;

e 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;

f marketing material used in the placement of the fund’s shares, including the prospectus, if any;

g 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);

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 4,373/14 must also be observed whenever such funds enter Brazil through the capital markets.39

38 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.

39 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, 1 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.
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.

It is also worth mentioning that, as of 27 December 2018, recent amendments introduced by the Brazilian Federal Revenue (RFB) in Rule No. 1,863 (IN 1,863/2018), 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,40 to provide the RFB with information on the relevant corporate chain, including trusts and foundations, up to the individuals deemed the ultimate beneficial owners, defined, with a few exceptions, as the (1) the individual or individuals who either directly or indirectly own, control or significantly influence41 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 absence of such an update, by 26 June December 2019 (180 days from the publication of IN 1,863/2018).42

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.

Investments made in the Brazilian financial and capital markets through CMN Resolution No. 4,373/14 are subject to favourable income tax treatment.43 Concerning FIPs specifically, the income arising from investment in these funds and gains arising from the sale

40 This obligation was also imposed on Brazilian entities by COCAD Declaratory Executive Act No. 9, of 23 October 2017, issued by the RFB.
41 Pursuant to Article 8, Section 2 of RFB Rule No. 1,634, as of 6 May 2016 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.
42 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) has extended the deadline, as mentioned above.
43 Section 3 of Law No. 11,312/2006.
or amortisation of FIP quotas by non-resident investors\textsuperscript{44} that are not resident or domiciled in a favourable tax jurisdiction\textsuperscript{45} are currently taxed at zero per cent, provided the following requirements are met (the FIP Requirements):

\(\textit{a}\) the non-resident investor does not hold, individually or with related parties (as defined by applicable legislation),\textsuperscript{46} 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);\textsuperscript{47}

\(\textit{b}\) 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;

\(\textit{c}\) 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

\textsuperscript{44} The FIP may also have Brazilian resident investors, but they will not benefit from this tax incentive.

\textsuperscript{45} 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 \textit{numerus 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.

\textsuperscript{46} 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{47} 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.
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).\(^48\)

Additionally, under another tax incentive regime\(^49\) 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 (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 quota holders 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);\(^50\)
- 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:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Taxes involved</th>
<th>Additional details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflow of funds as investment in an 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>
</tbody>
</table>

\(^48\) Section 11 of Bill No. 10,638/2018 intends to revoke this requirement (see below).

\(^49\) Section 97 of Law No. 12,973/2014.

\(^50\) 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 (CRIs), real estate investment funds (FIIs)).
### Brazil

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Taxes involved</th>
<th>Additional details</th>
</tr>
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<tbody>
<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>
</tr>
<tr>
<td></td>
<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>
</tr>
<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></td>
<td>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>
</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 an amortisation or redemption of FIP shares.</td>
</tr>
<tr>
<td></td>
<td>WHT: exemption (but taxed when further distributed to the FIP holders as WHT on capital gains)</td>
<td></td>
</tr>
</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 also 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.

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.

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51 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.
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 were not converted into law yet.

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 2019, the provisions upon conversion into law will only be in force as of 1 January 2020, 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 quota holders, 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 on gross revenues between zero and 9.25 per cent (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 until 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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52 Section 62, § 2 of Brazilian Constitution.
53 Sections 5, VI and 7 of Bill No. 10,638/2018 and Section 2, § 6, 7 and 8 of Law No. 11.312/06.
54 Corporate income tax (IRPJ/CSLL) and social contributions on gross revenues (PIS/COFINS) will be due by the FIP.
55 Sections 5, VII and 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 an 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 Instruction 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 quota holders 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 quota holder;
- quota holders 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 quota holders 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 2019, 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. This is largely 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 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

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56 Section 5, IV of Bill No. 10,638/2018.
57 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.

Another important amendment to CVM Instruction No. 409/04 (which was retained by CVM Instruction No. 555/14, which replaced CVM Instruction No. 409/04) has created rules to enable investment in companies with lower liquidity, authorising FMAs, when incorporated as closed funds, to repurchase the shares issued by the funds in the organised markets where the shares are admitted for trading, provided that:

a the repurchase price is lower than the book value of the share as of the day immediately prior to the repurchase;

b the repurchased shares are cancelled; and

c the amount of repurchased shares does not supersede, in a period of 12 months, 10 per cent of the total number of shares issued by the fund.

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.

As mentioned above, on 17 December 2014, the CVM enacted CVM Instruction No. 555/14, which replaced CVM Instruction No. 409/04 on 1 October 2015, establishing new provisions on the investment funds.

Amendments introduced by CVM Instruction No. 555/14 regard, inter alia, the valorisation of electronic means of communication, modernisation of information disclosure, as well as the relaxation of the limits of investment in certain assets, especially financial foreign assets.

Furthermore, this CVM Instruction has set out provisions on the following:

a 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 their net equity is invested in government bonds or bonds with equivalent risk;

b a prohibition on receiving remuneration that threatens the independence of a fund’s portfolio management;

c additional transparency in relation to the distribution policy of the fund’s shares;

58 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.
improvement of the rules related to the performance fee; and
safer rules for investments in foreign assets.

As regards item (e), 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 in item (a) 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 to initial investors and formed by low-risk assets, and whose portfolio managers shall have the duty to protect against volatility.

As regards 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 and emerging company FIPs, 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 now 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). 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.

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.

59 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.
The scenario is expected to be different for 2019 and the following years. After 13 years of a left-wing Workers Party government, interrupted by the impeachment of former President Dilma Rousseff and marked by several political scandals that culminated in the recession of the Brazilian economy, the election of the right-wing President Jair Bolsonaro in late 2018 seems to have directed Brazil on the right track for economic recovery. Bolsonaro has a conservative approach to economic issues, with promises to privatise state-owned enterprises and foster private business.

The swearing in of President Bolsonaro boosted the Brazilian stock market in the first week of 2019, and was one of the chief factors that led IBOVESPA to reach the top position in the world.60 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.

We believe that the Brazilian market is very promising for local and global players, especially considering the 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, as well as 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 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.

Finally, following a recent trend in the private equity industry, investments in distressed assets are also expected to catch investors’ interest in 2019. The economic turmoil in Brazil in recent years, as well as the difficulties in obtaining bank financing without clearance certificates, has led to insolvency, judicial and extrajudicial reorganisation, and bankruptcy for many companies. This situation has created opportunities for debt investors focusing on the provision of sophisticated restructuring solutions and funding for distressed companies and assets, especially in light of the economic turnaround that is forecast for the Brazilian market in the coming years.

As an example of this trend, a billion-reais private equity transaction involving one of the major Brazilian retail companies currently under an extrajudicial reorganisation is expected to close this year.

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Chapter 3

CANADA

Jonathan Halwagi, Tracy Hooey and Anabel Quessy

I   GENERAL OVERVIEW

After the historical heights that fundraising activity in Canada reached in 2017, the Canadian private equity market seems to have experienced a significant slowdown in fundraising in 2018. While industry reports covering the entirety of 2018 are not yet available, an industry report covering the first half of the year provided that no private equity firm had closed a fund in 2018. As a comparison, in 2017, private equity funds had raised a record-breaking C$11.6 billion.

Similarly, the start of 2018 has been slow for fundraising in venture capital with industry reports identifying only one venture capital firm that raised C$73.3 million for a seed-stage venture capital fund. As a comparison, in 2017, 15 Canadian venture capital firms had raised capital upwards of C$600 million.

While remaining well below the activity we have seen for 2017, fundraising for the second half of the year seems to have picked up slightly with a few notable fundraisings, such as Whitehorse Liquidity Partners closing the Whitehorse Liquidity Partners Fund II at US$1 billion hard cap, and Chrysalix Venture Capital completing its first close of the US$120 million Chrysalix RoboValley Fund.

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1 Jonathan Halwagi and Tracy Hooey are partners and Anabel Quessy is an associate at Fasken Martineau DuMoulin LLP.
2 This section is based on industry reports available in January 2019. 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.
5 Ibid.
6 Ibid. at p. 11.
7 Ibid. at p. 2.
These trends mirror the general movements of the North American and European market in which fewer funds, but higher average deal size and valuations have been observed over the past several years.10

While industry reports present a slow start to private equity and venture capital fundraising in Canada for the first half of 2018, industry participants anticipate that the Government of Canada’s support for the venture capital industry will contribute to its continued growth.11 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$400 million in large private sector-led funds-of-funds and in venture capital fund managers to increase the availability of late-stage venture capital in Canada.12 With funds from the private sector, this investment has the potential to inject around C$1.5 billion into Canada’s innovation capital market.13

II LEGAL FRAMEWORK FOR FUNDRAISING

i 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 below at Section III.i) 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’.14 In Manitoba, the Canadian jurisdiction, which 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’.15 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.16

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12 Ibid.
15 See sections 63(1) and 63(2) of the Partnership Act (Manitoba), C.C.S.M., c. P30.
16 Ibid.
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 (like Manitoba, for example, as described above).

**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 months 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.

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17 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).
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.

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

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18 Offering memorandums are also commonly referred to as private placement memorandums (PPM) and confidential information memorandum (CIM).
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 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 (GST) is applied at a 5 per cent rate, while a provincial component may be applied at a 8 per cent or 10 per cent rate depending on the province (collectively with the GST, 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.
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 2018, there was a total of 26,011 ELPs registered in Cayman. This is a 16 per cent increase on 2017 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. In 2018, the figure stood at 4,970, compared with 3,864 in 2017, 3,356 in 2016, 3,377 in 2015, 2,893 in 2014 and 2,368 in 2013.

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,
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 who 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 2018 remained robust, spanning a wide range of investment strategies and geographic focus.

II LEGAL FRAMEWORK FOR FUNDRAISING

Unlike open-ended mutual funds, closed-ended Cayman private equity funds are typically not required to register with the Cayman financial regulator, the Cayman Islands Monetary Authority (CIMA). (By closed-ended, we mean that investors are not entitled to voluntarily purchase or redeem their equity interests prior to the termination of the fund.) This distinction is created by the Mutual Funds Law (2015 Revision), which only requires registration where investors can withdraw at their own option. As it is a common characteristic of a private equity fund to lock up capital for the life of the fund, such funds are closed-ended for the purposes of the law. As such, the legal environment 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.

As already noted, 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) 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 later, 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 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 who takes part in the conduct of the business of the ELP can lose limited liability with respect to a third party who deals with that ELP and who reasonably believes the LP to be

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3 See, for example, Sections 14 to 19 and Section 37 of the Companies Law (2018 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.
8 Section 14(2) of the ELP Law.
a GP? However, all is not lost for an LP who 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 who 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 Law (2018 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

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9 Section 20(1) of the ELP Law.
10 Section 34 of the ELP Law.
11 Penal Code Law (2018 Revision), Sections 247, 248 and 257.
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 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;
- 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.’

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12 Section 175 of the Companies Law (2018 Revision).
13 Section 38 of the ELP Law.
14 Note that pursuant to Section 183 of the Companies Law (2018 revision), an overseas company selling securities from the Cayman Islands will first need to register as a foreign company under the Companies Law.
As previously noted, 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, willful default and gross negligence. It is worth noting that 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.\textsuperscript{15} 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

As noted above, closed-ended Cayman private equity funds are generally not required to register with CIMA. Care needs to be taken when drafting withdrawal provisions for an investor for regulatory reasons in an otherwise closed-ended fund, for example, where an LP wishes to exit for ERISA\textsuperscript{16} purposes. This is because the Mutual Funds Law does not exempt voluntary withdrawal in any circumstance. In practice, this is dealt with by turning the withdrawal ‘entitlement’ from one of right in the hands of the investor into one of compulsion in the hands of the GP.

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 (2015 Revision) (SIBL). This requires that a manager or adviser either be licensed by CIMA or register with CIMA as an excluded person. Registration as an excluded person does not imply regulation by CIMA, and such 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 the SIBL, or is a high-net-worth person (HNW). As most private equity funds are institutional, the latter test is usually relied upon as this sets the threshold for HNWs at US$5 million in total (as opposed to net) assets.\textsuperscript{17} The typical Cayman Islands private equity fund will easily reach this benchmark. Registration as an excluded person is achieved by filing a form on an annual basis that gives certain prescribed details with respect to the manager and payment of a fee of approximately US$6,000.

\textsuperscript{15} Section 19 of the ELP Law.
\textsuperscript{17} Section 2 of the Securities Investment Business Law (2015 Revision). Note that a different definition applies to an HNW natural person.
Registration under the SIBL will also bring the manager within the scope of Cayman’s robust and detailed anti-money laundering regime, and the manager will need to meet the client identification and reporting requirements prescribed by the Anti-Money Laundering Regulations 2018.

Of course, it is often the case that the GP will provide investment management or advice services to the ELP fund; however, the GP will typically be exempted from registration, 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.\(^\text{18}\) If it does, then it may be required to register as an excluded person.

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 (2018 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.

As previously noted, 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 tax-exemption certificate (TEC). The TEC will confirm that no law subsequently enacted in Cayman imposing any tax to be levied on profits or income or 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.\(^\text{19}\)

Currently, the TEC has insurance value only, as under current Cayman law there are no taxes levied in Cayman, which 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. Similarly, the Cayman regulatory regime has been very stable over the past year with no material changes in the context of a closed-ended private equity fund. Finally, it is worth noting that Cayman legislated away the unhelpful decision in the English case of *Mercury*:\(^\text{20}\) through changes to the Companies

\(^{18}\) Ibid., Paragraph 6, Schedule 4.

\(^{19}\) Section 38 of the ELP Law, as amended.

\(^{20}\) *R (on the application of Mercury Tax Group Ltd) v. HM Revenue & Customs [2008] EWHC 2721.*
Law. In summary, the judgment in *Mercury* appeared to require physical rather than 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.

As noted above, 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.

Again in 2014, Cayman introduced for the first time the 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 otherwise 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.21

The European Alternative Investment Fund Managers Directive (Directive) came into force in the EU and for adhering Member States of the 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 Directive vary depending on the location of the AIFM, but it should be noted that it applies equally to non-EEA-based AIFMs marketing Cayman Islands private equity funds to investors in the EEA and to EEA-based AIFMs who perform risk management or portfolio management functions for Cayman Islands funds even if they are not marketing. One requirement of the Directive 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.22

While a detailed analysis of the Directive 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 carefully consider the application of the Directive to such funds before any marketing or management activities are undertaken in the EEA. At the time of writing, the European Securities and

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21 Section 29 of the ELP Law.
22 See Articles 22 to 24 and 26 to 30 of the Directive for further details on the reporting, disclosure and asset-stripping rules.
Markets Authority (ESMA) is assessing whether it should recommend extending the Directive’s marketing 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 Directive 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 (AEOI) 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 Common Reporting Standard and the US Foreign Account Tax Compliance Act (FATCA) 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.


Following an overhaul of its anti-money laundering (AML) and terrorist financing regulations (the AML Regulations) in 2017, Cayman has continued in 2018 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, in December 2018, Cayman published the International Tax Co-Operation (Economic Substance) Law, 2018 and associated regulations. This new Law introduces 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 2018 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, and 2018 witnessed a record year for the jurisdiction with respect to the number of partnerships formed (4,917 in total, representing a 30 per cent increase on the prior year). 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 (especially Brazil) and Asia (notably China, Korea and Japan).

Notwithstanding the introduction of regulation of private equity managers in the United States and the EU, the Cayman Islands regulatory regime is not expected to change materially, meaning that the tried and tested, flexible and cost-efficient environment for private equity structures in Cayman will continue. That said, the Cayman Islands has responded to the increased regulation of the private equity industry across the world. There has been, and will continue to be, consequential changes resulting from the US FATCA and AEOI regimes, with increased reporting requirements being imposed on the Cayman Islands funds and the extension of Cayman Islands AML regulations to private equity funds. We expect many sponsors will outsource to administrators the reporting and compliance requirements imposed on them by the increased regulation, and rely on the administrators to ensure full due diligence is conducted with respect to the investors of their funds.

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 2019 will 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 the next few years will witness a significant growth in the jurisdiction’s share of the private equity and venture capital fund formation market.
Chapter 5

CHINA

James Yong Wang

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 telecom (TMT) industries,

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1 James Yong Wang is an investment fund specialist working in association with the PRC law firm of Jingtian & Gongcheng. The author acknowledges the assistance of his current and former team members, including but not limited to Yao (Ally) Hu, Yurui Lu, Xiao (Shawn) Ding, Zhiwei (Charles) Liu, Chenchen (Cici) Jiang, Xue Qiu and Shiyi Lin in preparing this chapter, and the contribution of his former colleague Wei (Abby) Mei.

2 Opinions vary in respect of the relationship between VC and PE. Some argue that VC refers to investments in start-ups or enterprises at their early stages while PE refers to merger and acquisition investments in privately offered equities of non-listed enterprises and listed enterprises. Some argue that PE covers all investments in non-publicly offered equities and thus VC is a branch of PE. However, rules differ in terms of the regulation of PE and VC and the regulatory authorities tend to make a distinction between the two. For instance, China Asset Management Association (AMAC), the self-regulatory organisation of the fund industry in China, divides private funds into securities investment funds, PE funds, VC funds, etc. Thus, in this chapter, unless otherwise mentioned, we distinguish between VC and PE and use PE/VC to describe investments in non-publicly offered equities.

3 For the purposes of this chapter, the People’s Republic of China (PRC), or China, or does not include Hong Kong, Macao and Taiwan.

4 The red-chip structure adopted by enterprises within the territory of China is a special transactional structure that is established for the purpose of overseas financing and IPOs. Usually, shareholders of enterprises within China establish overseas holding companies in offshore jurisdictions such as the Cayman Islands, and make the overseas holding companies acquire directly or indirectly equities of enterprises within China held by shareholders. In this way, ownerships of enterprises within China are transferred overseas.
the development of multi-layered capital markets domestically, and promulgations or amendments of relevant laws and regulations such as the Law on Partnership Enterprises, 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 December 2018, a total of 24,448 private fund managers (PFMs) managing 64,642 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 12.78 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 began to adopt 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 enterprises (FIVCEs) and domestic venture capital enterprises.

In August 2006, the Standing Committee of the National People’s Congress adopted the newly amended Law of the People’s Republic of China 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.

In June 2013, the State Commission Office for Public Sector Reform (SCOPSR) 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 PFMIs 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 (PIF Interim Measures), which established the system of registration of PFMIs and record filing of PIFs, defined qualified investor and clarified non-public fundraising and disclosure requirements for PFMIs. 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 (Fundraising Administrative Measures), the Guidance on Private Investment Fund Contracts, the Administrative Measures for Service Business of Private Investment Funds (for Trial Implementation) (Service Business Measures), the Guidelines on the Administration of Investor Suitability for Fund Raising Institutions (for Trial Implementation) (Suitability Guidance).

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, named the Guidance on Regulating Asset Management Business of Financial Institutions, 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. 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, PFMIs established in China (including PFMIs with direct or indirect foreign shareholders) must register with AMAC in accordance with the regulations formulated by AMAC. After the completion of fundraising, PFMIs have to register the PIFs managed by them with AMAC under the PFMIs’ 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, etc. 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 will be 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 (the Suitability Guidelines, and collectively with the Suitability Measures referred to as the New Suitability Management Regulations) promulgated by AMAC on 28 June 2017.

The PIF Fundraising Measures explicitly stipulates 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 has also stipulated 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 the 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.

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 (the Information Disclosure Measures) and the No. 2 Guideline for Information Disclosure for PE/VC funds (the No. 2 Guideline). 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).

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 LPs in a fund creates myriad issues. For example, SOEs are expressly prohibited from acting as the GP under the Chinese 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 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 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

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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.7

### 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.

### ii Insurance companies and the NCSSF

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. 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 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. To date, 24 insurance asset management companies have been approved to be set up by the CBIRC (or, prior to its consolidation under the CBIRC in March 2018, the China Insurance Regulatory Commission).

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).

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7 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.
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 past 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). Non-legal-person FIVCEs were also allowed to be treated as a tax pass-through entity, like 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 not to be able 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.

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

As discussed earlier, the Partnership Enterprise Law 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 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 of Circular Hui Fa [2015] No. 19 (Circular 19) in March 2015 and Circular Hui Fa [2016] No. 16 (Circular 16) in June 2016 by SAFE, 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). Circular 19 and Circular 16 are intended to put the rest of the country on the same level playing field as the several QFLP pilot areas. However, in practice, the QFLP pilot areas are still considerably ahead of the rest of China.


10 Beijing, Tianjin, Chongqing, Shenzhen, Qingdao (Guiyang Free Trade Zone), Pingtan and Zuhai 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 Gui [2017] No. 1 (New Shenzhen QFLP Rule) in September 2017, which improved the QFLP pilot programme it had formed in 2012. The implementation of the New Shenzhen QFLP Rule needs to be further observed in practice.
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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 managed onshore funds before, 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, Hony Capital and SAIF.

Over the past seven 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);11 (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 models (2), (3) and the New Model above are deemed to be foreign investors in terms of their investments and are required to go through the same foreign investment approval 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, which clearly provides 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 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 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

11 To learn more about the New Shenzhen QFLP Pilot programme Measures, please refer to the following Han Kun Private Equity Commentary: https://www.hankunlaw.com/downloadfile/newsAndInsights/5224dd932a1355c635a00f6b5424b092.pdf (Chinese).
nationals (e.g., Chinese members on the team or family members of the relevant principals) to set up a purely domestic LLC and putting 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 from 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 must be approved by the NDRC, and for ODI in non-sensitive projects records must be filed with the NDRC or the PDRC or disclosed to the NDRC identifying investors and detailing the method of investment and investment amount.

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
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 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 Sino-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 general partner 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 penalized 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, and which 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
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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 Circula 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 from 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, financial institutions, including PFMs 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 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.

13 The pilot areas include Beijing, Tianjin, Hebei, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xi’an, Shenyang and Suzhou Industrial Park.
14 Circular 38 has since been abolished by Circular Cai Shui [2018] No. 55.
15 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.
16 ‘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.
I GENERAL OVERVIEW

After a challenging 2016, in which only US$2.31 billion was raised by private equity funds (PEFs) and venture capital (VC) funds in Latin America, PEFs and VC funds raised a total of US$4.3 billion in, indicating a significant recovery. However, those figures remain well below the totals of US$10.39 billion and US$7.21 billion raised in 2014 and 2015 respectively.

In contrast to the overall trend in Latin America, fundraising by Colombian PEFs and VC funds has seen significant growth, from the US$12 million raised in 2014 to US$102 million in 2015, and US$106 million in 2016 (although, in 2017, only US$49 million was raised).

While in 2010 there were 30 private equity funds, with only 11 of those having finalised the fundraising period and 19 at the fundraising stage, in June 2018, 111 PEFs were active. Of these, 86 had closed the fundraising stage and 25 were still in the process of fundraising (three more than those reported by June 2017). As of June 2018, PEFs with operations in Colombia had received capital commitments for a total of US$35.23 billion for investments in Colombia and Latin America, in comparison to the US$28.59 billion in capital commitments received by the end of 2017. In 2018, Colombian PEFs at the fundraising stage aimed to raise US$1.58 billion for investments in Colombia and in Latin America, with US$514.1 million having been raised by June 2018. Furthermore, 58.8 per cent of the funds at the fundraising stage in June 2018 expected to achieve their financial close by the end of that year.

Of the amounts PEFs and VC funds expected to raise by June 2018, 40 per cent was expected to be raised by real estate funds, 16 per cent by venture capital funds, 16 per cent by buyout and growth financing funds, 12 per cent by environmental and social impact initiative funds, 12 per cent by infrastructure funds, and 4 per cent by natural resources funds.

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1 Hernando A Padilla is a partner and Pedro Arango is an associate at Philippi Prietocarrizosa Ferrero DU & Uría.
3 LAVCA, footnote 2, p. 3.
5 Ibid., footnote 2, p. 59.
6 Ibid., p. 58.
7 Ibid., pp. 47–49.
8 Ibid., p. 49.
The expansion of the private equity industry in Colombia is linked to the continuous growth of the economy since the early 2000s. Moreover, in the same period, the government has introduced regulations that have been welcomed by the private equity sector, and it has supported initiatives to promote the private equity industry. This includes new regulations regarding bankruptcy procedures, the adoption of the International Financial Reporting Standards, facilitating third-party valuation processes, and changes to the pension fund investment regime. In this context, it is worth highlighting Bancoldex, an entity designated by the government to invest directly in private equity and entrepreneurial initiatives, and to provide training and networking in aspects related to the private equity industry, and to promote it. As a result of these measures, Colombia has been recognised as an attractive and safe market for private equity investments.9

The above-mentioned statistics show that, in addition to the increase in the number of funds, PEFs have diversified in terms of the types of investments pursued by them. Infrastructure is a sector that has drawn attention and interest among investors and general partners (GPs). As a result of a solid public policy carried out by the government, support from national and international financial institutions, and governmental initiatives aiming to channel private and public resources into infrastructure initiatives, infrastructure projects have become a common investment area for recently incorporated PEFs.

As at June 2018, as the principal investors in PEFs (and the largest), pension funds continue to play an important role in the Colombian private equity market, providing 41.5 per cent of the capital commitments. Corporate investors lie in second place, with a 20.6 per cent share, followed by insurance companies and banks, which account for 5.9 per cent and 5.1 per cent of capital commitments respectively. The remaining 26.9 per cent is held by other investors, such as high-net-worth individuals (4.9 per cent), family offices (4.6 per cent), multilateral institutions (4.2 per cent), funds of funds (4 per cent), multi-family offices (3 per cent), sovereign funds (2.6 per cent) and endowments (3.1 per cent).10

Regarding the country of destination of the commitments, nearly 60.6 per cent of commitments are targeted at Latin American countries other than Colombia, with the remaining 39.4 per cent expected to be invested in Colombia.11

Recent significant fundraisings include the following:

a in 2017, BlackRock opened an infrastructure PEF looking to raise 825 billion Colombian pesos;

b in 2017, the Overseas Private Investment Corporation (OPIC), a US government agency, approved a US$488 million investment in developing countries, which included investment in Colombian real estate projects through its PEF, Avenida Capital Colombia Real Estate Fund II LP (CREF II);

c in 2017, Ashmore Colombia’s fund Andean Fund II achieved a final closing equal to US$248 million;

d in July 2018, OPIC committed to invest up to US$50 million in CREF II;

e in August 2018, the Colombian fund Fondo Inmoilario Colombia raised 420 billion pesos from the Canadian pension fund PSP Investments; and

9 According to LAVCA, Colombia currently ranks fourth, with the best regulatory landscape for private equity and venture capital investment in Latin America after Chile, Brazil and Mexico; see LAVCA, ‘2017/2018 Scorecard: The Private Equity and Venture Capital Environment in Latin America’, pp. 2–5.

10 EY, footnote 2, p. 61.

11 Ibid., p. 58.
in November 2018, the Canadian PEF Caisse de dépôt et placement du Québec and the governmental financial entity National Development Finance (known as the FDN) announced the launch of a fund that will invest in infrastructure projects, which expects to raise approximately US$1 billion.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Legal form and jurisdiction

Unlike in other jurisdictions, in Colombia PEFs do not have a corporate nature. Thus, they are not incorporated under a limited liability partnership or as a limited liability company. Under the Colombian regime, PEFs are collective investment vehicles, which do not have legal capacity and are governed by particular rules depending on their characteristics. PEFs have a contractual nature, which mainly consists in a private placement memorandum that sets out the fund’s rules, terms and conditions, and to which the LPs adhere.

Private equity funds are primarily regulated by Law 964 of 2005, Decree 2555 of 2010 (Decree 2555), which was amended by Decree 1984 of 2018 (see Section III), and the Legal Basic Circular issued by the Superintendence of Finances (SFC). Accounting rules are governed by the Accounting and Financial Circular issued by the SFC and the general accounting legal framework. In accordance with the definition of PEFs set out in Colombian regulations, these vehicles must invest at least two-thirds of their funds in assets or economic rights that differ from securities listed in the National Registry of Securities and Issuers (RNVE).

Private equity funds may be administered by three types of entities, broker-dealer firms, investment company administrators and trust companies, which are all supervised by the SFC. These institutions may decide whether to appoint a GP to manage the fund’s investments, and to carry out the investment and divestment policies or to carry out those activities themselves. Market practice shows that fund administrators tend to appoint a GP to manage each fund.

The legal structure of PEFs ensures that the assets of the fund are segregated from the assets of the administrator and from those of the GP, assuring the autonomy and independence of the assets. Thus, in the event of a reorganisation or winding-up of the administrator, or of the GP, the assets of the fund will not enter into the procedures.

Choosing to incorporate the fund in an offshore jurisdiction is not an uncommon practice for PEFs that expect to operate and invest in Colombia. For instance, as at June 2018, 55 (49.5 per cent) of the 111 PEFs active in Colombia were incorporated in a foreign jurisdiction.12

Colombian regulations require the participation of parties that are not familiar to foreign investors, such as a fund administrator and asset valuator. The mandatory participation of third parties entails additional transactional costs that have to be borne by the fund, affect returns and that may be avoided if the fund is incorporated offshore.

From a foreign exchange standpoint, international investors face a double foreign exchange risk, given that the capital commitments are originally delivered in US dollars to be converted into pesos, and, when the participations are redeemed, pesos must be converted into dollars. These transactions require the foreign investment to be registered.

12 EY, footnote 2, p. 46.
with the Colombian Central Bank and documentation to be filed with foreign exchange market intermediaries, which involves additional paperwork and costs. The registering of investments made by international limited partners (LPs) grants investors foreign exchange rights, including the withdrawal and transfer abroad of the dividends, profits and interests generated by the investments.

Finally, depending on the GP’s and LPs’ objectives and the allocation of the fund’s investments, private equity firms may seek tax-efficient structures that may entail the incorporation of offshore funds.

It is common for GPs to be incorporated in offshore jurisdictions and, as at June 2017, 49.2 per cent of the GPs were entities located abroad.\textsuperscript{13}

\section{Key terms}

Key concepts and common terms used in the Colombian private equity landscape are described below.

\textbf{Administrator}

As mentioned above, PEFs must have an administrator. These entities are supervised by the SFC, and hence must comply with both the regulatory obligations imposed on them and the relevant obligations regarding the administering of private equity funds. The obligations applicable to administrators mainly consist of:

\begin{itemize}
  \item exercising the economic and political rights of the fund’s assets;
  \item complying with the applicable information duties of the private equity fund, especially with the reporting obligations before the SFC;
  \item ensuring compliance with the applicable rules by the GP and the other actors involved in the private equity fund; and
  \item ensuring the compliance of the fund.
\end{itemize}

Where they exist, the administrator will be liable before the SFC and the investors for due diligence in the designation and monitoring of the GP, the foreign GP and the custodian.

\textbf{GPs}

An external manager is usually appointed to carry out the management activity of PEFs. The management activity mainly consists of performing the investment and divestment policy of the fund, as well as identifying, measuring, controlling and handling the risks of the fund. The private placement memorandum sets out the minimum requirements that the GP must meet to be appointed as the fund’s manager, which include experience, morality and suitability requirements. GPs must have the operative and technological infrastructure to manage the fund in accordance with the fund’s investment policies. Additionally, GPs must execute the fund’s investment policy in accordance with the private placement memorandum, the instructions provided by the investment committee and the management agreement.

The GP is a legal entity, usually a company, incorporated within Colombia or offshore, which enters into a management agreement with the fund’s administrator. To certify its experience, it can resort to the experience of its partners and individuals who will perform the management activities of the fund.

\textsuperscript{13} Ibid., p. 44.
**Limited partnership meeting**

The limited partnership meeting is composed of all the fund’s investors, including the GP if it invested in the fund. Each unit issued to the LPs confers one vote. The limited partnership meeting will appoint the members of the supervision committee and approve or reject the financial reports presented by the administrator (on limited occasions), and can remove the fund’s administrator and request the administrator to remove the GP.14

**Investment committee**

The members of the investment committee will be appointed by the GP. If there is no GP, one is appointed by the administrator. The investment committee is responsible for analysing investment alternatives and amounts, as well as the divestment and liquidation of investments. The private placement memorandum sets out the rules for the meetings of the investment committee, its functions and the requirements for the appointment of its members. The members of the investment committee are considered administrators for liability and fiduciary duty purposes.

**Supervision committee**

The supervision committee must oversee the administrator and the GP in the performance of their duties in accordance with the private placement memorandum and the applicable regulations. The members of the supervision committee will be appointed by the limited partnership meeting. Moreover, the supervision committee is in charge of assessing and solving conflicts of interest that may arise. The meetings of the supervision committee will be held on at least a quarterly basis.

**Compartments**

PEFs may have one or more compartments with different investment policies. If the fund decides to establish compartments, the private placement memorandum and the prospectus will provide a description of their main characteristics. In the event that compartments are set up, a compartment may be available for a specific class of investor, and may establish different fees and investment strategies. Prior to the issuance of Decree 1984 of 2018, compartments could be composed of only one investor; however, one of the main changes introduced by the new legislation is the requirement for compartments to have two or more investors. Each compartment will issue its own participation units.

The possibility of setting up compartments allows PEFs to attract investors that are looking for specific investment conditions, co-investment opportunities and investment alternatives that align with the GP’s objectives.

**Capital commitments**

Investments made by the LPs into the PEF are made through capital contributions. The private placement memorandum sets out the minimum conditions and amounts for the capital commitments. To invest in a private equity fund in Colombia, the current minimum

14 The current proposal to amend PEFs’ regulation eliminates the faculty of the limited partnership meeting to request the GP’s removal.
commitment must equal 600 monthly legal minimum wages, which in 2019 amounts to 496,869,600 pesos. However, the private placement memorandum may set out a higher amount for the minimum amount of capital commitments.

Usually, in adhering to the private placement memorandum, the LPs undertake to pay the capital commitments within a set period or once the capital commitment is made by the GP in accordance with the private placement memorandum. Decree 2555 allows the possibility of making in-kind contributions, provided that this alternative is explicitly included in the private placement memorandum.

**GP commitment**

GPs tend to make investments in private equity funds managed by them. This practice is broadly welcomed, given that it ensures the alignment of interests.

**Private placement memorandum**

The private placement memorandum is the governing document for private equity funds in Colombia, as it sets out the terms and conditions that will govern all the fund’s activities and investments. The private placement memorandum must include, *inter alia*, the following information:

- a. general features of the fund (such as name of the fund, ID number, term, domicile, minimum number of investors and minimum amount of commitments);
- b. the fund’s investment policy;
- c. the general terms that will rule the agreement entered with the GP (if appointed);
- d. functions and composition of the investment committee;
- e. functions and composition of the supervision committee;
- f. mechanism for the distribution of profits;
- g. administration and management fees;
- h. rules and powers of the limited partnership meeting, and liquidation events; and
- i. liquidation procedures.

Private placement memoranda are reviewed by the SFC before the private equity fund commences its operations. Any amendment to the limited partnership agreement (LPA) must be submitted to the SFC for its review.

**Investment limitations**

Apart from the limitation on investing at least two-thirds of its funds in assets different to registered securities in the RNVE, PEFs do not have significant limitations regarding their investments.

**Fees and distribution mechanisms**

Fees charged in Colombia by administrators and GPs are similar to those under international standards. Thus, administration and management fees range between 1.5 and 2 per cent, whereas the carried interest is commonly 20 per cent. The high-water mark usually varies between 6 and 12 per cent.
The distribution of profits of Colombian PEFs tends to follow the traditional waterfall scheme. The model for the distribution of profits is based on the whole-fund model in contrast to the deal-by-deal model. Nonetheless, certain early-stage funds do have deal-by-deal carried interest schemes.

**Co-investments**

Private placement memoranda usually have a provision regarding the possibility of undertaking co-investments together with the sponsors of the fund. This provision is established in the private placement memorandum, and sets the rules that will govern such co-investment.

**Key-man provisions**

Because of the increase in the number of private equity funds and investment alternatives, some of these are specialising in specific sectors. As a result, key-man provisions have become critical to attract investors interested in investing in these sectors. Such provisions usually stipulate that, if a key person leaves the fund, the investment period may be suspended while a substitute previously approved by the investors is appointed. Infrastructure-focused funds provide a recent example, with experienced individuals being appointed in their investment teams to attract investors. Key-man provisions are governed by the contractual terms negotiated between the fund’s administrator and the GP.

**Participation units**

Participation units correspond to the participation of the LPs in private equity funds. Participation units are issued to the LPs once payment of the agreed capital commitments has been made. Unless stated otherwise in the LPA, capital commitments will not grant voting rights until the capital commitments have been paid in full, in accordance with the terms of the private placement memorandum. Furthermore, participation units of private equity funds are automatically listed in the RNVE and become publicly traded, provided that a decision to this effect has been included in the private placement memorandum. The valuation of the funds’ participation units is calculated on a daily basis.

The Colombian regulatory framework allows PEFs to issue different types of participation units based on the LPs that invest in the fund. Each type of participation unit may set out different rights and obligations, such as, *inter alia*, the management rules for a participation unit’s redemption. Nevertheless, the conditions, rights and obligations of each type of participation unit must be clearly described in the private placement memorandum. In practice, it is common that the participation units issued to the GP that invested in the fund confer different rights than those subscribed by the other investors. Said differentiation may be useful at the moment of distributing the profits in a waterfall model.

**Disclosure**

Decree 2555 and the SFC have determined the key items that have to be disclosed.

In addition to the private placement memorandum, the prospectus of the fund must also be disclosed. The prospectus is the document the administrators use to carry out the promotion of the fund. It must contain at least general information about the fund, the investment policy and its risk profile, and the fund’s economic information, and it must identify the GP (if a GP is appointed). Moreover, this document must be written in Spanish, has to be consistent with the information set out in the private placement memorandum.
and cannot contain any misleading information. The investment policy shall include the investment plans, the type of target companies or investments to be undertaken, the guidelines for selecting such investments, the economic sector and the geographical locations of the investments.

The data technical sheet includes the basic information about the fund, which has to be updated on a daily basis pursuant to the instructions of the SFC. Colombian regulations require the fund’s administrator to publish on the fund’s website the private placement memorandum, the prospectus and the technical data sheet, among other documents.

Decree 2555 sets out a disclaimer that must be included in the fund’s documents, stating that the obligations of the fund’s administrator are undertakings that do not guarantee any outcome or result, the funds provided by the investors are not considered deposits and hence are not covered by the general fund of financial guarantees of financial institutions, and the investment commitments are subject to the investment risks related to the funds’ investments.

Solicitation

In connection with solicitation of investors, Colombian regulations do not establish specific limitations for the promotion of PEFs located in Colombia, apart from the obligation to provide truthful and clear information regarding the fund and the entities related to it (i.e., mainly the administrator and the GP). Decree 2555 and the Legal Basic Circular set out the disclosure data that has to be publicly available.

As a result of the reduced number of potential Colombian investors who invest in the asset class, GPs initiate the promotion of a PEF before the fund is set up. This is to identify the requirements and profile sought by potential investors, so that the GP and the administrator can include these conditions in the private placement memorandum and the prospectus. This practice is more evident in the case of pension fund administrators, which, because of their importance as potential investors and their strict investment criteria, have to verify whether the PEF will comply with all the requirements applicable to them, and with the investment profile sought by the pension fund’s assets; likewise, the GP seeks to attract the pension fund administrator, and therefore will try to design the private placement memorandum to suit these requirements as long as they are in line with their own objectives.

As to fiduciary obligations, pursuant to Colombian regulations, the fund’s administrator, the GP and the members of the investment committee owe fiduciary duties to the LPs and are considered administrators in accordance with the definition of administrator under Law 222 of 1995.15 Decree 2555 states that administrators and managers will be held liable for slight negligence (the lowest threshold), and that they shall act as prudent experts in the performance of their management duties as managers of private equity funds.16 Because of the fiduciary responsibilities of the fund’s administrators and the GP towards the LPs, administrators, GPs and members of the investment committee must adhere to principles and obligations such as observing a duty of care towards the investors, acting in good faith,

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15 Law 222 of 1995 sets out the obligations and duties required of officers and directors (considered administrators within the scope of Law 222).

16 Insurance companies have introduced insurance policies for GPs.
and looking after the best interests of the LPs and of the fund. In addition, administrators and GPs are obligated to act in accordance with the applicable regulations, the LPA and the principles governing private equity funds.17

### III REGULATORY DEVELOPMENTS

Because of the structure of PEFs, the entity that serves as fund administrator is supervised by the SFC. Hence, the administrator will have to comply with both the specific obligations applicable to PEFs and the obligations imposed on supervised financial entities.

Private equity funds must be registered before the SFC. Although Decree 2555 states that PEFs do not require prior authorisation for registration, a procedure must be undertaken by the administrator to register with the SFC. The administrator files the private placement memorandum and other ancillary documents with the SFC and, as of this filing, the private equity fund is entitled to start operations. However, the SFC may provide observations and modifications to be included in the private placement memorandum. Once any such modifications have been made, the SFC will issue a communication stating that it has no further objections or comments. GPs do not have to register to undertake their managing activities in Colombia. However, pursuant to Decree 2555, GPs must comply with specific disclosure obligations resulting from the performance of their management activities.

For tax purposes, PEFs are considered pass-through entities, as they are subject to the tax-transparency principle, therefore any income received by the PEF in connection with its economic activities will be transferred directly to the LPs, preserving its initial nature. All income will be considered earnings of the LPs as if the PEF did not exist and as if the economic activity had been carried out directly by the LPs. Bearing in mind the above, the applicable tax provisions will depend on several factors inherent to the LPs and the type of income (i.e., if the LP is considered resident for tax purposes or the source of income).

To date, most of the divestiture of portfolio companies by PEFs has been through sales to strategic investors or other private equity funds. Any asset that has been held for over two years will be taxed at a rate of 10 per cent; otherwise, it will be taxed at a rate of 33 per cent for transactions occurring in 2019, 32 per cent for transactions occurring in 2020, 31 per cent for transactions occurring in 2021 and 30 per cent for transaction occurring in 2022.

A non-exhaustive list of both recent regulatory developments and draft regulations currently under discussion includes the following:

\[a\] Law 1819 of 2016 introduced a structural tax reform that includes:

- income tax on dividends, levied at a rate of 35 per cent;
- tax on dividends distributed to non-Colombian residents levied at a rate of 5 per cent;
- a tax on the import, sale and consumption of oil and gas derivatives used for energy purposes;
- a tax on passive income resulting from investments made by Colombian residents in foreign companies, including but not limited to dividends; and

17 On 20 July 2017, a bill of law was filed before the Colombian Congress under which managers’ fiduciary duties regime would be amended. One of the main changes would be the introduction of the business judgement rule in Colombian law. At the time writing, the bill of law had not been approved by the Colombian Congress.

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• the unification of income tax and equity tax (CREE) (including its surplus), which will be levied at a rate of 40 per cent for 2017, a rate of 37 per cent for 2018 and a rate of 33 per cent from 2019 onwards.

b Decree 765 of 2016, whereby the Colombian Ministry of Finance and Public Credit (MHCP) modifies pension funds’ investment regime to:
• reorganise admissible assets in accordance with a risk-based approach, allowing segregation of traditional assets and alternative assets;
• introduce a new category of assets – ‘restricted assets’ – aimed at contributing towards the diversification of risks associated to pension funds; and
• modify investment caps and requirements for currently admissible assets, especially for investment vehicles incorporated by foreign issuers.

c Decree 2103 of 2016, whereby the MHCP modifies the insurance company investment regime in the following ways:
• to include the local and foreign real estate PEFs as eligible assets in which those entities may invest;
• to replicate the constrains and restrictions applicable to pension funds with respect to investments in PEFs the main assets of which are infrastructure projects; and
• to modify the maximum percentage of the insurance companies that can be allocated in PEFs.

d External Circular Letter 15 of 2016, whereby the SFC modified the rules applicable to the valuation of PEF assets.

e External Circular Letter 35 of 2016, which provided instructions regarding the ownership structure reports that PEFs must submit to the SFC.

f External Circular Letter 54 of 2016, whereby the SFC added certain rules regarding factoring operations and trading of economic rights and securities not listed in the stock exchange.

g Decree 1756 of 2017, whereby the MHCP set out certain rules applicable to investments made by Colombian investors in foreign investment vehicles (including PEFs and VCs).

h External Circular Letter 37 of 2017, whereby the SFC modified the rules applicable to the valuation of PEF portfolios.

i Decree 1984 of 2018, whereby the MHC completely and comprehensively amended the PEF regime by removing the existing cross-references to the CIF regime. Thus, many of the rules included in the CIF regime were expressly retained in the PEF regime. However, the Decree also introduced certain new rules applicable to PEFs, such as the following:
• PEFs are now authorised to carry out certain operations such as issuing bonds in the stock exchange and granting financing; and
• valuation of the PEF’s portfolio (formerly a duty of the PEF’s administrator) must be assigned to the GP under the new regime.

j Law 1943 of 2018 (effective as of 1 January 2019), which has introduced certain tax reforms, the most relevant of which for the private equity market is the amendment of the tax deferral regime applicable to private equity fund income. Under the former regime, all of funds’ earnings were subject to tax deferral since the tax was levied at the point when those earnings were distributed to the LPs. Under the new regime, this tax deferral applies only with respect to (1) funds listed in the stock exchange, or (2) funds in which more than 50 per cent of the fund’s equity interest is neither
owned, directly or indirectly, by one person, nor is there a beneficial owner or LP with control of the approval of the distribution of more than 50 per cent of the fund’s equity interest. PEFs set up prior to 31 December 2018 must comply with these requirements by June 2020 to be eligible for the tax deferral regime.

IV OUTLOOK

During the past few years, the amounts of capital commitments denominated in dollars have exceeded those denominated in pesos. As at June 2017, 68.7 per cent of the capital commitments of active funds were denominated in dollars, and in the same month in 2018, 66 per cent of PEFs’ capital commitments were denominated in dollars. This could be the result of the strong devaluation of the peso against the dollar, making denomination of capital commitments in dollars more attractive, to mitigate the risk of devaluation. Other possible factors behind this trend include the increased stake held by foreign investors in the Colombian PEF market and the number of foreign PEFs investing in Colombia.

Following recent trends in fundraising activity in Colombia, the industry expects that real estate and infrastructure PEFs to have the major stake of the capital commitments raised in Colombian market. In fact, of the US$1.06 billion that the PEFs aimed to raise as of June 2018, US$735.2 million (69.1 per cent) was expected to be raised through real estate and infrastructure PEFs.

Finally, number of venture capital funds is expected to increase over the next few years. In fact, of the PEFs at the structuring stage in June 2018, 33.2 per cent were venture capital funds; these were followed by buyout and growth financing PEFs with a 27.8 per cent share of the total, and by real estate and infrastructure PEFs, each of which had a 16.7 per cent share.19

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18 EY, footnote 2, p. 59.
19 Ibid., pp. 47–49.
Chapter 7

GERMANY

Felix von der Planitz, Natalie Bär and Maxi Wilkowski

I 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.

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

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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 MiFID\(^6\) 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. German limited partnerships (KG), limited partnerships on shares (KGaA), GmbH and stock corporations (AG) 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.

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 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 sourced 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;
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.

IV 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 8

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 an international hub and gateway to China, as well as 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 currently amounts to US$141 billion. The Hong Kong private equity industry is strengthened by its diversity. Long a preferred destination for global and regional private equity sponsors, 36 of the top Asia-focused funds based on size have a managerial presence in Hong Kong. Hong Kong is an important jurisdiction for leading pension funds, insurance companies, sovereign wealth funds and other limited partners. Consistent with its position as a leading private wealth management hub, asset managers and family offices also play a prominent role in Hong Kong’s private equity sector.

Asset management and fund advisory businesses in Hong Kong grew by 23 per cent to HK$17,511 billion in 2017 amid a global economic upswing. In addition to this remarkable growth in managed capital, the private equity industry also saw an increase over the past few years in the number of licensed corporations and personnel. From September 2017 to September 2018, 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 that private equity fund managers are most likely to hold – grew by 8 per cent, 12 per cent and 12 per cent respectively. Over the same period, the number of individuals licensed in Hong Kong for Type 1, 4 and 9 regulated activities similarly increased by 2 per cent, 9 per cent and 9 per cent respectively.

In addition to benefiting from strong economic tailwinds for much of 2018, the growth of the private equity sector in Hong Kong also reflects Hong Kong’s important role in China’s
Belt and Road Initiative (BRI), one of Chinese President Xi Jinping’s signature initiatives, focused on infrastructure and investment across the globe, and the continued development of the Guangdong–Hong Kong–Macao Greater Bay Area. A number of private funds focused on the BRI and the Greater Bay Area were launched successfully in 2018, and this activity is likely to continue in 2019 in support of these critical initiatives.

Heading into 2019, Hong Kong will be well positioned to face any headwinds thanks to numerous tax and legal changes initiated in 2018 by the Hong Kong authorities, including: a proposed 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 and comfort in the Hong Kong private funds market; and tightened regulation over funds investing in virtual assets, to support and promote responsible innovation.

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 encompass 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 required to complete a supplemental Hong Kong investor questionnaire to ensure their professional investor status. In addition, certain categories of professional investors, including individuals, are subject to enhanced compliance and due diligence requirements.

To the extent that 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 the 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.
The private equity fund structure most commonly offered in Hong Kong comprises a fund organised as a limited partnership, with a general partner organised either as a limited partnership or as a company, and an investment manager organised as a company, often under the laws of the Cayman Islands or other offshore jurisdiction. 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 adviser entity that employs the professionals and generates investment advice and operational support in respect of the investments that the fund proposes to make. Activities of an investment adviser could, depending on the facts and circumstances, come within various categories of regulated activity 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 it manages. As a result, any such Hong Kong investment adviser entity would probably 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 active-marketing test corresponds to the concept of ‘solicitation’ commonly used in other regulatory regimes. The SFC places emphasis on whether:

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.6

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. As a result, if a company is considering engaging in the distribution and sales of securities such as limited partnership interests, where marketing is involved, a Type 1 licence would be required. In addition, engaging in deal sourcing and the execution of private equity transactions (including participation in negotiations with a target company) may also fall into the category of Type 1 regulated activity.

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

Type 9 (asset management) regulated activity includes the managing of real estate investment scheme or securities or futures contracts. If a company wishes to provide portfolio management services, then the company will require a Type 9 licence.

As the profile of each private equity firm with a managerial presence in Hong Kong may differ depending on such factors as strategy, business capabilities, operational model and personnel, many firms decide to apply for one or a combination of the Type 1, 4 or 9 licences, while some other firms instead seek to rely on an exemption from the licensing requirements. The SFO sets out various exemptions from the licensing requirements, the most relevant of which we discuss below.

Incidental exemption

A company may not require a licence for certain regulated activities if the 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, that company may rely on the incidental exemption to carry out Type 1 and Type 4 regulated activities provided that these activities are undertaken solely for the purposes of the company’s asset management business.

Dealing with professional investors exemption

A company may not require a licence for futures or securities dealing activity if the company acts as principal and only deals with certain professional investors.
Group company exemption

A company may not require 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, the company’s holding company, which holds all the company’s issued shares, or to other wholly owned subsidiaries of the company’s holding company.

Licensing criteria

Licence for the corporation

The core principle behind the Hong Kong licensing regime is that the applicants must demonstrate to the satisfaction of the SFC that they are fit and proper to be licensed. Being fit and proper involves, broadly, being financially sound, competent, honest, reputable and reliable.

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 detailed business plan, compliance manuals and operation flowcharts, as well as any other documents demonstrating that the corporate applicant has a proper business structure, good internal control systems and qualified personnel to ensure the proper management of risks that the company will encounter in operating the business set out in the business plan.

Responsible officers

The applicant must appoint at least two responsible officers (ROs) to be tasked with directly supervising the conduct of each proposed regulated activity, with at least one RO available at all times to supervise each proposed regulated activity, and at least one RO designated as an executive director.

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

12 Authorised financial institutions, such as banks, are required to be registered instead of licensed. This article is focused on issues relating to fully licensed corporations.
13 See SFO §129.
14 See SFC Licensing Handbook (April 2017), Fit and Proper Guidelines (October 2013), Guidelines on Competence (March 2003), and Guidelines on Continuous Professional Training (March 2003), issued by the SFC.
15 The same individual may be appointed to be a responsible officer 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.
16 ‘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.
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.

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:

a) display of licence or certificate of registration;
b) availability of ROs;

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17 ‘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.

18 ‘Officer’ means a member of the senior management (including directors, responsible officers and Managers-In-Charge of Core Functions), manager or secretary of, or any other person involved in the management of, the corporation.
notification requirements;
submission of audited accounts;
payment of certain annual fees; and
continuous professional training.

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

Private equity funds offered in Hong Kong tend to be domiciled in tax-neutral, offshore
jurisdictions such as the Cayman Islands. This is driven in part by tax considerations. Funds
that are domiciled outside Hong Kong may be exempted from Hong Kong profit tax if
certain conditions under the Inland Revenue Ordinance (Cap. 112) are met. The profit tax
implications may vary for fund managers, which are commonly entitled to receive asset-based
management fees and variable performance fees. Although a Hong Kong-based investment
adviser often manages the operation of the fund, profits and income are often kept by the
Cayman-based fund manager through contractual arrangements to control the extent of
Hong Kong tax. In recent years, taxation of fund managers and advisers in Hong Kong
has drawn tighter 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 adviser under a transfer pricing analysis. In the current
market, sponsors of private equity funds must carefully review the service agreements among
managerial entities alongside the underlying compensation arrangements to anticipate any
challenges from the IRD.
Recent developments

FMCC amendments

On 17 November 2018, an amended version of the FMCC came into effect. The SFC explained that the amendments to the FMCC are meant to implement financial policy reforms in the wake of the global financial crisis, and that the reforms are influenced by work undertaken by international bodies, including the International Organization of Securities Commissions, the Financial Stability Board and other regulatory bodies. The FMCC’s objective, as amended, is to help ensure that Hong Kong’s regulatory regime is adequately robust and in line with recent, international regulatory developments.

Although the amended FMCC applies to all SFC licensed or registered persons with a business involving the management of collective investment schemes or discretionary accounts, certain critical requirements apply only to a fund manager that is ‘responsible for the overall operation of the fund’ (ROOF). While the facts and circumstances must be examined to determine whether a particular manager is a ROOF, the SFC’s apparent intention is to capture a fund manager that is responsible for day-to-day fund management operation. The SFC has offered, by way of example, that if the representatives of a fund manager or its subsidiaries constitute a majority of a fund board, then the fund manager may be considered a ROOF.

The amended FMCC enhances certain obligations and imposes new requirements, covering areas such as securities lending and repurchase agreements, the safe custody of fund assets, proper liquidity risk management and the disclosure of leverage.

New regulatory approach for cryptocurrency assets

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.

A virtual asset, in brief, is a digital representation of value and is referred to commonly using such terms as cryptocurrency, crypto-asset or digital token. Many virtual assets do not squarely fit within the definition of securities or futures contracts and thus would arguably fall outside the SFC’s regulatory jurisdiction. On this basis, the management of funds investing solely in virtual assets and the operation of platforms that solely provide trading services for virtual assets might appear not to constitute a regulated activity as specified under the SFO. However, if firms are engaged in the distribution of funds that invest thereafter in virtual assets, then, irrespective of whether the assets constitute securities or futures contracts, these firms would be required to be licensed by or registered with the SFC. This is because the interests in such funds would be securities and the distribution of such fund interests would be a Type 1 regulated activity.


To improve investor protection, the SFC has developed a set of terms and conditions to better address the risks posed by virtual assets. These terms and conditions will be imposed as licensing conditions on virtual asset portfolio managers that have a stated investment objective to invest in virtual assets or that intend to invest or have invested more than 10 per cent of the gross asset value of their managed capital in virtual assets. Such portfolio managers are, furthermore, required to inform the SFC of such intentions or of any existing management.

In addition, the SFC proposes to explore how to regulate virtual asset trading platforms in a more tailored manner by working with certain virtual asset trading platform operators that have demonstrated a commitment to high standards of conduct.

**Profits tax exemption expansion**

On 7 December 2018, the Hong Kong government gazetted the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the Bill) to introduce changes to the existing profits tax exemption for privately offered funds. The Bill was subsequently introduced into Hong Kong’s Legislative Council on 12 December 2018 and is expected to come into effect on 1 April 2019.

The purpose of the Bill is to address the concerns of the Council of the European Union over the ring-fencing features of Hong Kong tax regimes for privately offered offshore funds, and to enhance the competitiveness of Hong Kong tax regimes by creating a level playing field for all funds operating in Hong Kong. To achieve this objective, the Bill unifies the profits tax exemptions for privately offered funds so that all funds in Hong Kong, regardless of structure, location of central management and control, size or purpose, can enjoy the profits tax exemption for their transactions in specified assets, subject to certain conditions. A fund can also enjoy the profits tax exemption from investment in both offshore and local private companies. Moreover, to counteract tax evasion, the Bill also introduces certain anti-abuse measures.21

### III 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, Hong Kong

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will likewise continue to closely monitor and regulate the conduct of the private equity industry in a way that embraces and benefit from China’s economic boom, the new global economy and growing financial integration.
I GENERAL OVERVIEW

The private equity (PE) landscape in India entered a matured phase in 2018 with consistent investment inflow, an increase in the number of exits and continued accumulation of dry powder. Certain trends unique to 2018 are worth noting.

Renewed interest shown by global PE and M&A investors in India and an expanding footprint of global pension funds and sovereign wealth funds in India (by stepping up their investments in the infrastructure and real estate sectors) were reassuring for the Indian market. There was a sudden spike of interest in stressed assets because of the enactment of the Insolvency and Bankruptcy Code (which also took India higher up on the World Bank’s ranking for ease of doing business). The resultant increase in the sale of stressed assets offered new opportunities to PE funds.

There was a shift in focus on governance and deleveraging as a result of which the number of control deals and buyouts increased in 2018.

There was an increase in deal values (despite the decline in deal volumes), namely a surge in billion-dollar deals. 2018 also saw a drastic increase in exit activity, evidenced by the fact that exits worth approximately US$25 billion were recorded in 2018, compared with US$14 billion in 2017. In addition, secondary sales gained importance as a mode of exit in comparison to initial public offerings (IPOs), the most popular exit mode in 2017.

2018 v. 2017

The highest-ever fundraising total was recorded in 2018, with US$8.1 billion raised across 51 funds and US$22.3 billion worth of fundraising plans announced. The total amount of funds raised through the year shows a 40 per cent increase in comparison to 2017’s total, which had a reported aggregate fundraising total of US$4.9 billion. While the year had a tepid start, with US$3.1 billion being raised in the first quarter of 2018 (which was on a par with

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1 Raghbir Menon and Ekta Gupta are partners and Deepa Rekha and Srishti Maheshwari are senior associates at Shardul Amarchand Mangaldas & Co.
the fundraising activity in the first quarter of 2017), the second quarter of 2018 came out strong, with US$1.7 billion raised, as against US$719 million raised in the second quarter of 2017. As result, the first half of 2018 showed a 50 per cent increase in fundraising when compared to 2017, with a reported US$3 billion worth of funds raised. The third quarter saw the highest-ever quarterly fundraising figures at US$2.6 billion (a 17 per cent increase from 2017).

The largest fundraising of 2018 was also the largest logistics real estate fund ever raised in India. This was the US$1.2 billion real estate fund raised by IndoSpace, a leading developer of industrial real estate and warehousing facilities in India. Sequoia raised US$695 million for its sixth India-focused fund, which will focus on early and growth stage investments in the technology, consumer and healthcare sectors. The US$600 million buyout fund raised by True North Capital (formerly India Value Fund Advisors) was the third-largest fund raised in 2018 and is expected to raise an additional US$900 million, underlining global investors’ faith in Indian fund managers. Other significant fund raises were the funds raised by Godrej Fund Management: (1) US$450 million for Godrej Build To Core-I, an office investment fund, and (2) US$150 million for Godrej Office Fund-I, a discretionary blind pool fund. Motilal Oswal Private Equity Advisors Pvt Ltd raised its third fund, India Business Excellence Fund III. This is its largest-ever fundraising, at approximately US$330 million, of which almost 75 per cent was contributed by domestic investors. The fund will focus on the financial services, consumer and healthcare sectors. Nexus Venture Partners, one of India’s leading home-grown venture capital (VC) firms, raised US$313 million (70 per cent of the targeted US$450 million) for its sector agnostic fund. Evidently, the most significant fundraisings of 2018 were by home-grown funds.

In addition to the funds raised, some significant fundraisings are in the pipeline. The National Investment and Infrastructure Fund and DP World Private Limited announced their plans to raise a US$3 billion fund to invest in ports, terminals, transportation and logistics businesses in India. The Global Steering Group for Impact Investment, successor to the Social Impact Investment Taskforce established by the G8, proposes a massive fundraising of US$2 billion (through two funds of US$1 billion each) to invest in social enterprise
initiatives in India. Further, Everstone Group and Lightsource BP have entered into a joint venture to set up the Green Growth Equity Fund, a US$710 million fund to invest in the infrastructure and energy sector in India.

ii Industry sector trends

Unlike in 2017, sector agnostic funds did not dominate fundraising activity in 2018. In a continuation of the trends seen in previous years, the real estate, consumer technology and financial services sectors witnessed a substantial amount of fundraising activity. There were two significant fundraisings in the small and medium-sized enterprise sector: the US$200 million fund raised by the Indian subsidiary of the Industrial and Commercial Bank of China to invest in local start-ups and small firms, and the US$127 million fund raised by IndiaNivesh, its maiden fund, which will focus on turnaround opportunities among small and medium-sized enterprises. The state government of Rajasthan launched a US$77 million fund for promoting start-ups, with a part of the resources allocated for women-led start-ups and green-solution start-ups.

iii Real estate and infrastructure

The real estate fund of US$1.2 billion raised by IndoSpace and the two funds (US$600 million in aggregate) raised by Godrej Fund Management were the largest real estate sector funds raised in 2018. Other real estate and infrastructure sector funds raised or announced include the US$300 million India-focused infrastructure fund raised by Morgan Stanley, the US$218 million fund (India Realty Excellence Fund I) raised by Motilal Oswal Real Estate, the US$297 million fund raised by Edelweiss Alternative Asset Advisors for investment in the infrastructure sector, and the US$208 million fund announced by realty firm Puravankara.

iv Sector agnostic funds

The US$600 million buyout fund raised by True North Capital and the US$313 million fund raised by Nexus Venture Partners were among the significant sector agnostic fundraisings in 2018. In addition, SeaLink Capital announced the closure of its US$315 million maiden

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20 https://www.vccircle.com/indianivesh-marks-first-close-for-turnaround-fund/.
21 https://inc42.com/buzz/rajasthan-startup-fund/.
22 https://www.livemint.com/Companies/A3aKCV430pO7PjGBmNG1K/Morgan-Stanley-raises-300-million-for-India-focused-infrast.html.
fund, a sector agnostic that will focus on medium-sized companies.\textsuperscript{27} Greater Pacific raised US$300 million in the first close of its targeted US$700 million fund, which will target investment opportunities greater than US$50 million in value in sectors such as healthcare, technology and services.\textsuperscript{28} AION Capital, a joint venture between Apollo Global and ICICI Venture, has announced its second fund (which will be a sector agnostic fund) with a targeted corpus of US$1 billion.\textsuperscript{29} Lastly, the Lighthouse fund, an India-focused PE fund, raised a US$200 million fund to invest in small consumer-driven ventures.\textsuperscript{30}

\textbf{v  Financial services and consumer technology}

India Business Excellence Fund III, Motilal Oswal Private Equity Advisors Private Limited’s third fund of US$330 million, which will focus on the financial services, consumer and healthcare sectors.\textsuperscript{31} Sequoia’s US$695 million India-focused fund has been raised for early and growth stage investments in the technology, consumer and healthcare sectors.\textsuperscript{32} Lightbox Ventures raised US$178 million out of the targeted US$200 million for its third fund, which will focus on investments in fast-moving consumer goods, financial services, education and healthcare.\textsuperscript{33} Matrix Partners India raised US$300 million for its third India-dedicated fund for investment in consumer technology.\textsuperscript{34} The US$113 million fund raised by TVS Capital will focus on financial services and the healthcare sector.\textsuperscript{35}

\textbf{vi  Investments and exits}

The investment trends in 2018 were reflective of the growing maturity of the Indian market as 2018 saw more nuanced and high-value PE investments. The total investment value (at US$35.1 billion) increased by 35 per cent in comparison to 2017 (US$26.1 billion). There were 12 deals of value greater than US$500 million (including eight deals of value greater than US$1 billion) during the year.\textsuperscript{36} The US$1.7 billion investment by GIC, KKR, PremjiInvest and OMERS in HDFC Limited for a minority 3.9 per cent stake was one of the largest deals.\textsuperscript{37} Other prominent deals were the US$1.3 billion investment by a consortium of Warburg Pincus, Softbank, Temasek and other global investors for acquisition of a
28 per cent stake in Airtel Africa, the US$1 billion investment in hospitality-tech start-up Oyo Rooms by Greenoaks Capital, SoftBank, Lightspeed Ventures and Sequoia Capital, and the US$1.6 billion investment by Macquarie Group in the National Highways Authority of India’s Toll-Operate-Transfer Bundle I. There was a strong uptick in investments in the infrastructure and real estate sector. Buyouts were at an all-time high, as evidenced by 48 buyouts at US$9.8 billion in aggregate (roughly equal to the combined value of the buyouts from the previous three years). The increase in buyout deals reflects a clear shift in focus from growth capital or minority deals to control deals. KKR’s acquisition of a majority stake in Max Healthcare and a 60 per cent stake in Ramky Enviro Engineers were among the significant buyout deals of 2018. The US$1.6 billion investment by Macquarie Group in National Highways Authority of India’s Toll-Operate-Transfer Bundle I, the acquisition of Equinox Business Park by Brookfield for US$384 million, the acquisition of information technology (IT) park SP City by Temasek through Mapletree Investments for US$353 million, the buyout of Phoenix Group’s office project in Hyderabad by Xander for US$350 million, and the buyout of Indiabulls Properties Private Limited by Blackstone for US$346 million were the noteworthy deals in the infrastructure and real estate sector, as well as being the largest buyout deals of 2018.

After peaking in 2015 and then declining in 2016 and 2017, investments in start-ups increased dramatically in 2018 and surpassed the record set in 2015. The largest deals were the US$1 billion investment by Softbank, Sequoia and Lightspeed in Oyo Rooms, the US$1 billion investment in Swiggy (food delivery mobile application) by DST Global, Naspers, Tencent and Hillhouse Capital, and the US$1 billion investment by Warburg Pincus to set up a business processing management platform, Vivtera, in association with

40 https://www.livemint.com/Industry/ChOPRLmYXw0mYFWZByYWQl/Macquarie-Group-wins-Indias-first-ToT-project-with-a-bid-of.html.
44 https://www.livemint.com/Industry/ChOPRLmYXw0mYFWZByYWQl/Macquarie-Group-wins-Indias-first-ToT-project-with-a-bid-of.html.
Indian former IT executives.\textsuperscript{51} Private investment in public equity, a major trend in 2017, saw a meagre 3 per cent increase, which can be attributed to the volatile market conditions in the second half of 2018.\textsuperscript{52}

The past year was a phenomenal one for exits. The value of PE/VC exits was US$26 billion, which is an increase of nearly 100 per cent compared with the value of exits in 2017, and is equal to the combined value of exits over the previous three years. While Walmart’s US$16 billion acquisition of Flipkart from multiple investors (including Softbank and Tiger Global) contributed significantly to this increase, strategic and secondary exits increased markedly in 2018. The strategic sale of business process outsourcing firm Intelenet Global Services Private Limited by Blackstone for US$1 billion,\textsuperscript{53} the US$769 million buyout of Vishal Mega Mart Private Limited by Partners Group and Kedaara Capital,\textsuperscript{54} and the secondary acquisition of Star Health and Allied Insurance Company Limited by WestBridge Capital and Madison Capital for US$745 million\textsuperscript{55} were the largest secondary or strategic exits of 2018. Open market exits and PE-backed IPOs, on the other hand, slowed down this year (declining by more than 70 per cent in terms of value, and by more than 56 per cent in volume in comparison to 2017) because of the volatility in the market caused by global trade wars and the headwinds on the Indian macroeconomic front.\textsuperscript{56}

\textbf{vii} \hspace{1em} Reception by limited partners and fund managers

India has proven to be a volatile market, with drastic upward and downward trends in its perceived attractiveness over the past few years, starting in 2008 when it ranked second, then in 2014 falling down to the eighth spot, then topping the list in 2017 before slipping to the second spot to 2018.\textsuperscript{57} In this context, according to a market survey conducted by the Emerging Markets Private Equity Association, better opportunities for growth, the increasing number of exits and improved choices in fund managers have been cited as factors that make India attractive, while the perceived competitiveness of the investment environment due to its increasing attractiveness and high entry valuations have been cited as deterrents.\textsuperscript{58} Given the importance placed on exit prospects by PE investors and the fact that a weak exit environment in India has been cited as a deterrent for investment in the past, the increase in exit activity has instilled confidence in investors by showing that investments in India hold promise and this has resulted in liquidity of funds for further investments.\textsuperscript{59} However, India

\begin{footnotesize}
\begin{enumerate}
\item https://www.livemint.com/Companies/7R77MlYp0ETyY5LA31cr9H/Kedaara-Partners-Group-to-complete-Vishal-Mega-Mart-acquis.html.
\item https://www.bloombergquint.com/business/westbridge-madison-rakesh-jhunjhunwala-to-acquire-star-health-insurance#gs.kGGKk5YQ.
\end{enumerate}
\end{footnotesize}
still faces the problem of lack of local participation in funds and fund management. This can
be attributed to funds not being allocated to India by the India-based private equity investors,
as well as to regulatory factors that do not encourage pooling of funds in India.60

While 2018 ended on a high note, an uncertain political environment in India owing
to the impending general elections in 2019, the volatility of the Indian rupee and the
detrimental effect of the surge in oil prices on India’s fiscal condition are factors that are likely
to impact PE activity in India.61 However, with the positive global outlook on India intact,
and fair returns on investment coupled with increasing investment opportunities, limited
partners (LPs) and fund managers continue to remain hopeful.

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 general partner (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
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 below.

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, as of November 2015, the Reserve Bank of India (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 alternative investment funds (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 venture capital 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 venture capital 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,\(^62\) Category II AIF,\(^63\) and Category III AIF.\(^64\) 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 and Category II AIF has to be at least 2.5 per cent of the corpus (at any given point) of the AIF or 500 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 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 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 real estate investment trust (REIT) must register with SEBI to conduct their business.

An REIT is a trust formed under the Indian Trust Act 1882 (the Trust Act) and registered under the Registration Act, 1908 (the Registration Act) 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. The sponsor is responsible for the creation of the trust. Each REIT is allowed to have a maximum of three sponsors, with each of them having a net worth of not less than 200 million rupees and a collective net worth of not less than 1 billion rupees.

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\(^{62}\) An AIF that invests in start-up or early stage ventures or social ventures or small and medium-sized enterprises or in infrastructure or other sectors or areas that the government or regulators consider socially or economically desirable (including venture capital funds, SME funds, social venture funds, infrastructure funds, angel funds and such other AIFs as may be specified).

\(^{63}\) 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.

\(^{64}\) 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 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 an REIT to invest only in special purpose vehicles (SPVs) or properties or transfer development rights in India or mortgaged-backed securities. An 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 an REIT, an InvIT is a trust formed under the Indian Trust Act 1882 and registered under the Registration Act 1908. 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 SEBI InvIT 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.

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 September 2018, Embassy Office Parks and Blackstone Group filed an offer document with SEBI for a 50 billion rupee issue. Hopefully other PE players will follow suit to stimulate growth in an otherwise unattractive sector for investment. 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, the details of which have been set out below.

v 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 venture capital fund or AIF distributes this to the 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 2018 in AIFs have risen 30 per cent up to 1.8 trillion rupees. Further, a restriction on allocating foreign portfolio investors (FPIs) 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.

ii  Preferred jurisdictions for offshore funds

Background

As stated earlier, 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.

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 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.

As stated earlier, 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 three 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 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.

### iii 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 Department of Industrial Policy and Promotion (DIPP) of the Ministry of Commerce and Industry, and the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2017 (FEMA20R). Under FEMA20R, 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 shall be reclassified as FDI.

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
India

(FIPB). In furtherance of its announcement in 2017, the government abolished the FIPB in 2017. In place of the FIPB, the government of India 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. One year 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 SEBI (Foreign Portfolio Investors) Regulations 2014 (the FPI Regulations). 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 FPI Regulations. The regulations impose a ceiling on the individual holding of an FPI, which must be below 10 per cent of the capital of the company, and an aggregate limit for FPI investment of 24 per cent of the capital of the company. This aggregate limit of 24 per cent may be increased up to the sectoral cap or statutory ceiling, as applicable, subject to, *inter alia*, prior notice to the RBI. FPIs must be registered with a DDP before dealing in securities as an FPI. The process is fairly simple and ordinarily it does not take more than 30 days to obtain the certificate. Clubbing of investment limits for FPIs is done on the basis of common ownership of more than 50 per cent or based on common control. As regards common-control criteria, clubbing shall not be done for FPIs in the following cases: (1) FPIs that are appropriately regulated public retail funds; (2) FPIs that are public retail funds majority owned by appropriately regulated public retail funds on a look-through basis; or (3) FPIs that are public retail funds whose investment managers (IMs) 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 or shareholders’ agreements or voting agreements, or in any other manner.

Under the current FPI regime, Category I FPIs are restricted to those who are residents of a country whose securities market regulator is either a signatory to the International Organization of Securities Commission’s Multilateral Memorandum (IOSCMM) or has a bilateral memorandum of understanding with SEBI. Category I entities are essentially governments and related entities or multilateral agencies and are perceived to be the highest-quality and lowest-risk investors. To increase the volume of investments through the FPI route, SEBI is proposing to expand the list of eligible jurisdictions by including additional countries that have diplomatic tie-ups with India.

In December 2017, SEBI, with the intention of providing ease of access to FPIs, approved certain changes, 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 FPIs. Market participants have welcomed all these changes as pragmatic steps by SEBI to enhance the flow of institutional capital into India.

**FVCI route**

The FVCI route was introduced with the objective of allowing foreign investors to make investments in venture capital 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 the Securities and Exchange Board of India (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 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 (the ICDR Regulations). 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. Previously, it was restricted to biotechnology, IT, nanotechnology, seed research and development, discovery of new chemical entities in the pharmaceutical sector, the dairy industry, poultry industry, production of bio-fuels, hotels and convention centres with a seating capacity of over 3,000, and the infrastructure sector; the approval of the securities regulator was not required for investment in these sectors.

**III THE INSOLVENCY CODE**

As predicted, bankruptcy played a huge role in influencing the M&A trends in 2018, with the Insolvency Code being a work in progress and multiple amendments energetically pushed through to strengthen the legal framework for bankruptcy in India. One of the key amendments introduced through the ordinance effective from 6 June 2018 was the reduction in the voting threshold from 75 per cent to 66 per cent of the committee of creditors with respect to key decisions. This change has enabled quick decision-making, allowing for approvals of viable resolution plans. Another welcome amendment was the reduction in the scope of ‘connected persons’ who are barred from bidding for companies under the Code. Prior to the ordinance, several financial entities having connected persons through investee companies in India or abroad were barred from bidding for companies. The amendment provides a relaxation in respect of these entities, so long as they are not related to the corporate debtor.

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 is set to
hit the trillion-rupee mark as there are several high-profile deals pending. However, the most significant change is the evidence of promoters behaving better in relation to lenders and no longer enjoying an upper hand when negotiating deals with the 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 last year by the industry from SEBI’s interpretation of the AIF Regulations was for the investment manager to pay careful attention while drafting the investment objectives in the PPM.

SEBI reprimanded SREI multiple asset investment trust (SMIT) 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

As stated earlier, following the adoption of 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 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 five 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:

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<th>REITs</th>
<th>Sponsor/investor</th>
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</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).

**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 remould 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 conditionalities in e-commerce

The DIPP issued Press Note 2 of 2018 on 26 December 2018 amending the policy regarding FDI in entities engaged in the marketplace model of e-commerce. Formerly, the policy stipulated that the e-commerce entity cannot exercise ownership or control over the inventory (i.e., goods purported to be sold). The amendments went on to clarify that the inventory of a vendor is deemed to be controlled by an e-commerce marketplace entity if more than 25 per cent of the vendor’s purchases are from the marketplace entity or its group companies. Further, the amendment lays down a restriction on an entity having equity participation by an e-commerce marketplace entity or its group companies; or on an entity having an e-commerce marketplace entity or its group companies control the entity’s inventory to sell the entity’s products on the platform run by the e-commerce marketplace entity. While the changes have been brought in to appease domestic brick-and-mortar businesses, the amendments are definitely a big blow to e-commerce retailers such as Amazon and Flipkart. Having said that, all market participants have sought clarity on certain interpretational issues to ensure their businesses are compliant with the restrictions.

ii Constitution of the National Financial Reporting Authority

The year 2018 also witnessed a string of corporate frauds that raised concerns among investors in relation to corporate governance and credit worthiness of portfolio companies. As an immediate response, the government approved the establishment of the National Financial Reporting Authority (NFRA) as an independent regulator for the auditing profession under Section 132 of the Companies Act 2013. The jurisdiction of the NFRA will extend to listed companies and large unlisted public companies, and it will have the power to monitor and enforce compliance of accounting and auditing standards. It is supposed to oversee the quality of service and undertake investigation of the auditors of listed entities. If during investigation the NFRA finds non-compliance with the Companies Act 2013 involving fraud amounting to 10 million rupees or more, it shall report its findings to the central government. The move is being heralded as a step in the correct direction towards preserving the credibility of India as a safe destination for investments.

iii REITs and InvITs

In 2018, SEBI amended the guidelines for public issue of units of REITs and InvITs with a view to further rationalising and easing the issuing process. The amendments include allocation to anchor investors to be on a discretionary basis and subject to a minimum of
two investors for allocations of up to 2.5 billion rupees, a minimum of five investors for allocations of more than 2.5 billion rupees, and alignment of the definition of institutional investors with the definition in the ICDR Regulations. The duration of the period for announcement of a price band or floor price by the manager of a REIT or InvIT under Clause 8(3) has been reduced from five working days to at least two working days prior to the opening of the bid. The bidding process under Clause 9 has been modified to provide for acceptance of bids using the Applications Supported by Blocked Amount facility for making payment, facilitated through electronic bidding platforms to be provided by recognised stock exchanges. On 25 January 2019, SEBI released a consultation paper in relation to further amendments to the regulations governing InvITs, on relaxing trading rules. If the amendments are implemented, the minimum subscription amount for an investor in an initial public offering and follow-on offer of an InvIT will be reduced to a range of 15,000 to 20,000. After initial listing, the trading lot should also be in multiples of 100 units. This proposal indicates a move by SEBI to include retail investors within the ambit of the InvIT investor community.

iv Operating guidelines for AIFs in IFSC

In November 2018, SEBI prescribed detailed operating guidelines to regulate AIFs in India’s first International Financial Services Centre (IFSC) set up under Section 18(1) of the Special Economic Zones Act 2005 in Gujarat International Finance Tec-City, Gujarat. This is 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, the FDI or the FPI routes. 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 Integrated online reporting of foreign investments in India

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 ARF and FC-GPR, is merged into a single revised FC-GPR. At present five forms, FC-GPR, FC-TRS, LLP-I, LLP-II and CN, are being made available for filing using the SMF. With effect from 1 September 2018, all new filings for these five form categories have to be done using the SMF only.

VIII OUTLOOK

In 2018, record-breaking M&A and fundraising activity were witnessed owing to myriad factors, including the enactment of the Bankruptcy Code, simplification of the regulatory regime and further liberalisation of the FDI regime. With deal activity in 2018 having set the bar particularly high, the first few months of 2019 should see investors treading cautiously on account of both political uncertainty in India (at least until the lead-up to the general elections in India) and global uncertainty, with events such as Brexit having an impact on emerging markets such as India. Having said that, there is a tacit acknowledgment among global PE investors that India continues to have a huge appetite for foreign investments,
India

with no comparable level of opportunity worldwide. Strong macro drivers, such as strong demographics, a burgeoning consumer segment and policies promoting a favourable business environment, are expected to keep investors focused on the Indian market in 2019.

From a sector perspective, we expect investors to show interest in e-commerce, financial services, healthcare and logistics. The coming years will witness many more buyouts or control transactions, including large corporate carve-outs and family businesses exploring exits; this would also involve family-run businesses proactively seeking value addition from global private equity firms to help scale up their businesses.
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 and then increased to €6.239 billion in 2017. New commitments totalled €1.664 billion in the first half-year of 2018. Of the total 2017 commitments, private fund managers raised only €920 million, which increased to €1.289 billion in the first half-year of 2018. Of the 2017 commitments raised by private fund managers, 28 per cent was made by international investors, increasing to 50 per cent in the first half-year of 2018. Funds of funds, family offices and individual investors were the larger investors, accounting for an overall 44 per cent of the total commitments in 2017 (29 per cent in the first half-year of 2018). While banks’ commitments are slowly increasing, Italian pension funds continue to allocate limited resources to private equity funds (14.4 per cent and about 5 per cent respectively of the total commitments in the first half-year of 2018). There were 21 firms engaged in raising funds in 2017 (18 in the first half-year of 2018).

Private equity and venture capital funds raising money in 2017 and 2018 included Charme III (in excess of €500 million at final closing in 2017), Gradiente II (€60 million at first closing in 2017), Arcadia Small Cap II (€47 million at first closing in 2017), UV2 (€75 million at first closing in 2017), Fondo Technology & Innovation (€30 million at first closing in 2017), QuattroR (€711 million at first closing in 2017), Fondo Italiano d’Investimento’s FoF VC (€163 million at final closing in 2017), Innovazione e Sviluppo (€150 million at first closing in 2017), FII Tech Growth (€50 million at first closing in 2017), FSI Mid-Market Growth Equity Fund (€1.25 billion at third closing in 2018), F2I’s third fund (infrastructure – €3.6 billion at final closing in 2018), Ambienta 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), Progressio Investimenti III (€127.7 million at second 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), IGI Investimenti
Sei (€100 million at first closing in 2018), Fondo Agroalimentare Italiano (€40 million at first closing in 2018) and B4 H II – Fondo EuVeca (€43 million at first closing in 2018).

With some exceptions reflecting the current market 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 infrequent 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 recently been introduced 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.

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.
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 under EU directives (UCITS) and other funds, including private equity funds (alternative investment funds or 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 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 22.
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. Legislative 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. joint Regulation of the Bank of Italy and the Italian Securities and Exchange Commission (Consob) dated 29 October 2007, as amended, setting out the organisational requirements to be met by, among others, AIFMs;¹²

e. Consob Regulation No. 20307 of 15 February 2018, 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.

¹² This Regulation is expected to be replaced by the regulatory provisions of the Bank of Italy mentioned in footnote 24.
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, only a few cases exist of Italian funds managed by AIFMs of other EU jurisdictions acting under the AIFMD passport provisions. These include some private debt funds and the funds managed by a full-scope UK AIFM into which the SGR previously managing them was merged.

SICAFs

As mentioned above, 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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13 €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.

14 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 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.
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. MFN 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 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 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);\(^{15}\)

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,\(^{16}\) 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.

\(^{15}\) See footnote 21.

\(^{16}\) 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.

**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.

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 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.

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17 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.
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).

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

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** 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
- **c** institutional investors established in a whitelisted country (this definition includes entities whose activity consists in 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).

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.

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18 Note that a full exemption applies to Italian and foreign investors holding units of Italian (or EU or whitelisted EEA) 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.
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 grant a 50 per cent exemption from personal income taxes, for up to five years, to qualifying new residents in respect of income that they earn from employment or from self-employment activities performed in Italy.

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); in practical terms, only income and 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

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19 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.

20 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.


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.

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 EuVECA Regulation was amended in 2017 to eliminate some perceived obstacles to a wider diffusion of these funds. Under the amended Regulation – effective 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 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

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24 The implementing process of MiFID II includes regulatory provisions of the Bank of Italy introducing new corporate governance and organisational requirements for fund managers (also covering whistle-blowing and outsourcing of cloud services). Following publication of a consultation document in 2018, the process is expected to complete in 2019.

25 In accordance with the ESMA Guidelines on MiFID II product governance requirements of 2 June 2017 (ESMA35-43-620).
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 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 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 invest funds also in other EU 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.26

While this scenario is unlikely to evolve quickly, some recent legal developments may impact on the industry in the short term. In January 2019, the European Banking Authority (EBA) issued final guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of the Capital Requirements Regulation (CRR).27 These guidelines clarify that the notion of investments in venture capital firms and private equity contained in Article 128(2) CRR only applies to ‘direct investments and whenever the look-through approach is used for exposures in the form of shares or units in collective investment undertakings’. As a result, banks’ exposures to private equity funds are not treated as being

26 Including Equity Partners Investment Club, promoted by Mediobanca.
necessarily associated with high risks under Article 128(2) CRR (which would result in such exposure receiving a risk weight of 150 per cent). Hopefully, this clarification will be of help to banks wishing to increase their investments in private equity funds.

Pursuant to legislation introduced at the end of 2016 (and initially modified in 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. The benefit is aimed at incentivising direct and indirect investments in Italian business entities and in EEA business entities with a permanent establishment in Italy. To this end, at least 70 per cent of the PIRs’ assets must be invested in financial instruments (equities or bonds) issued by these entities, and at least 30 per cent of this 70 per cent must be in financial instruments issued by entities not included in the main index of Borsa Italiana nor in equivalent indexes of other regulated markets. These requirements may be met also indirectly, by investing in PIR-compliant funds. 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). The amount invested in PIRs was about €11 billion in 2017. The aggregate size of PIR schemes increased in 2018 but at a slower pace partly because of volatility in the public markets. So far, PIRs have targeted predominantly public equities and open-end funds. To mitigate this trend, the legal regulation of PIRs changed in December 2018 such that PIRs are now also required to invest money in certain unlisted equities. In particular, under the new provisions at least 3.5 per cent of the PIRs’ assets must be invested in venture capital funds that are established in Italy or in other EEA countries and that in turn invest 70 per cent or more of their assets in Italian SMEs and EEA SMEs with a permanent establishment in Italy.

Other ongoing and future developments that are expected to affect the industry structure include the following.

As part of the European Commission’s Capital Markets Union Action Plan, in March 2018 the Commission published a proposal (consisting of a regulation and a directive) designed to optimise the EU passport and to improve cross-border distribution of funds in the EU within the context of, among other things, the AIFMD and the EuVECA Regulation. This proposal notably includes provisions harmonising the definition of and conditions for pre-marketing of funds within the EU with a view to ensuring that the notion of marketing is consistently applied by EU national regulators, so that AIFMs can carry out pre-marketing activities in all EU Member States under the same (harmonised) conditions. The Council and the European Parliament’s ECON Committee have already defined their positions on this proposal, and a final agreement before the 2019 European elections looks possible.

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.

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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 21 per cent of total investable assets.
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, it is likely that a number of Italian managers wishing to market their funds in additional EU jurisdictions will consider registering 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.

31 See Section III.iv.
I GENERAL OVERVIEW

In Japan, no official statistics are published by any government organisation on the size of the private equity fundraising markets or the number of private equity funds offered in Japan.

Although there are no government-published statistics, the Japanese fundraising markets have remained strong, as the Bank of Japan’s negative interest rate policy seems to be pushing Japanese pension funds, financial institutions and other investors in Japan to consider allocating more money to alternative investments (including private equity funds) that have the potential to achieve greater profits than investments in government bonds or other traditional assets. Japan’s Government Pension Investment Fund has increased its investment in alternative investments, including private equity funds (both onshore and offshore), and many other pension funds seem to be following this trend.

Private equity funds offered in Japan include funds that make private equity investments in Japan managed by Japan-based fund operators or offshore fund operators, as well as funds that make private equity investments outside Japan managed by Japan-based fund operators or offshore fund operators. Many of the Japan-based fund operators are now launching third, fourth or fifth funds, and new fund operators established by professionals that have spun-off from existing Japan-based fund operators are also launching their new funds. Amid the strong interest in alternative investments by investors, institutional investors have shown increased interest in co-investment deals. Naturally, the high demand and strong interest in alternative investments have increased the diversity of alternative investment funds, and not only traditional buyout or venture capital funds, but also infrastructure funds, real estate funds, funds of funds and other funds with special themes are offered in Japan.

II LEGAL FRAMEWORK FOR FUNDRAISING

Limited partnerships (LPSs) are the legal structures most commonly used as vehicles for private equity funds offered in Japan – typically offshore limited partnerships organised under foreign law, and limited partnerships for investment business (JLPSs) organised under the Limited Partnership Act for Investment Business in Japan. Historically, private equity funds managed by non-Japanese fund operators have often used Cayman Islands-exempted limited partnerships as the fund vehicles for private equity investments offered to investors in Japan, and Japan-based fund operators have mainly used either Cayman Islands-exempted limited

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1 Keiko Shimizu is a partner at Nagashima Ohno & Tsunematsu.
partnerships or JLPSs. These days, an increasing number of non-Japanese fund operators are offering LPs formed in other offshore jurisdictions to investors in Japan, and an increasing number of Japan-based fund operators are using or considering using JLPSs for offerings to investors in Japan and Cayman Islands-exempted limited partnerships for offerings to offshore investors and Japanese investors who choose to invest through offshore vehicles.

Other possible fund structures under Japanese law include a general partnership (NK) established under the Japanese Civil Code. These alternative vehicles are also pass-through vehicles for Japanese tax purposes but the JLPS is usually the first choice of Japan-based fund operators as it provides limited liability for its limited partners and is treated as a pass-through vehicle for tax purposes. With regard to an NK, on the other hand, its partners’ liability in regard to claims against them brought by bona fide third parties will not be limited. One disadvantage of the JLPS structure is that the Limited Partnership Act for Investment Business limits the scope of investments that can be made by a JLPS. Generally speaking, a JLPS may not invest more than 50 per cent of its assets in foreign securities (i.e., securities issued by non-Japanese issuers), and because of this restriction a JLPS cannot be used for private equity funds that invest mainly in securities of non-Japanese companies. In this chapter, it is assumed that the fund under discussion is organised as a foreign limited partnership (a foreign LPS) or a JLPS (collectively referred to as LPS funds) unless reference is specifically made to another type of vehicle.

The Financial Instruments and Exchange Act of Japan (FIEA), which is the main statute encompassing securities regulations in Japan that not only sets out the rules for securities offerings but also regulates securities brokers and fund managers, is basically applicable if either an investor of a fund vehicle or the general partner of an LPS fund is in Japan. As a general rule, unless one of the exemptions from registration applies (as discussed below in more detail), a fund operator of a foreign LPS or JLPS will have to be registered as a financial instruments business operator under the FIEA to make an offering of foreign LPS interests or serve as the investment manager of the fund’s assets.

General rules for offering of interests in, and conducting investment management of, LPS funds

Where an offering of LPS fund interests is made in Japan, the entity conducting the solicitation, in principle, is considered to be engaging in the business of offering securities in Japan, and thus is required to be registered as a financial instruments business operator engaging in Type II financial instruments business (Type II registration) under the FIEA. If a general partner of an LPS fund solicits investors in Japan to invest in the LPS fund, the general partner will, in principle, be required to obtain Type II registration. However, if the general partner delegates all solicitation activities to a third party (which, in principle, is required to have Type II registration) and does not itself engage in any solicitation activities, then the general partner does not have to obtain Type II registration.

In addition, in the case of private equity funds, as the assets of the LPS fund will be mainly invested in securities, the general partner will, in principle, be considered to be engaging in investment management business and thus will have to be registered as a financial instruments business operator engaging in investment management business under the FIEA (investment manager registration). Unlike the Type II registration discussed above, the

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3 Civil Code (Act No. 89 of 1896).
general partner, generally, will be subject to the investment management business regulations even if it delegates the investment management authority to another investment manager entirely. This investment manager registration requirement is only triggered when 50 per cent or more of the assets of the LPS fund is invested in securities or derivatives.

**ii Exemptions from the registration requirements**

The FIEA provides several exemptions from the registration requirements discussed above.

**Qualified Institutional Investor special business exemption**

One of the exemptions used by many general partners is an exemption from both the investment management business registration and Type II registration requirements (the Qualified Institutional Investor (QII) special business exemption), which is available to the general partner of a fund structured in the form of a partnership. This QII special business exemption is available when the Japanese investors investing in the LPS fund consist of at least one QII and 49 or fewer non-QIIs who meet the statutory criteria, and the general partner meets certain other criteria (see Section III). This exemption is only available to the general partner and is not available to a third party that has been delegated the responsibility for solicitation of the interests in the LPS fund or the authority to perform the investment management of the fund assets. Therefore, if an investment manager who is not the general partner of the fund vehicle were to engage in solicitation activities in Japan, the investment manager would not be able to qualify for the QII special business exemption and would have to obtain Type II registration, unless other exemptions from registration requirements apply.

If a general partner qualifies for the QII special business exemption, the general partner must file a notification (an Article 63 Notification) with the Local Finance Bureau (and in the case of a foreign general partner, with the Kanto Local Finance Bureau) prior to commencing business in Japan. Also, the general partner who files the Article 63 Notification will be subject to certain compliance requirements (including the appointment of an agent or representative in Japan and, in the case of a foreign general partner, adherence to certain code-of-conduct rules and disclosure requirements, and maintenance of certain statutorily required books and records).

Requirements for the QII special business exemption were substantially amended, with effect from 2016. The requirements and regulations applicable to the QII special business exemption following this amendment are outlined and discussed in Section III below.

**Outsourcing of solicitation activities**

Although not strictly an exemption from the registration requirements, as discussed above, if a general partner outsources marketing activities entirely to a third party (usually a firm with a Type II registration) and does not engage in any solicitation activities by its own actions, then the general partner is not required to have Type II registration and does not have to concern itself with exemptions from registration requirements. This means that if a general partner does not engage in any solicitation activities in Japan by its own actions by engaging a private placement agent, there is no requirement for the general partner to file Article 63 Notification prior to accepting investors in Japan. However, it should be noted that the definition of solicitation that triggers the registration requirement under the FIEA is broad, so if the general partner has direct communications with a potential investor or investors, those communications may be considered solicitation if the communications relate to the fund or a potential investor’s possible investment in the fund.

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Foreign fund or de minimus exemption for investment management

For foreign LPSs, there is a special exemption from the investment management registration requirement (the foreign fund exemption, often also referred to as the *de minimus* exemption). In essence, this exemption is available when: (1) the fund's direct investors in Japan are limited to QIIs and persons who have submitted an Article 63 Notification with respect to the investment management of the fund; (2) the fund’s indirect investors who invest through partnerships formed under Japanese law (indirect investors) are limited to QIIs; (3) the fund has fewer than 10 direct and indirect investors in Japan in total; and (4) the amount invested by the fund’s direct investors in Japan is one-third or less of the total amount invested by all investors in the fund. With reference to the foreign fund exemption (*de minimus* exemption), a direct investor is a resident of Japan who directly holds interests in a foreign LPS, and an indirect investor is a resident of Japan who holds interests in partnerships formed under Japanese law (such as a fund of funds formed under Japanese law, including a JLPS, NK, TK or LLP) that hold interests in a foreign LPS.

Outsourcing of investment management activities to investment managers registered under the FIEA

The general partner may be exempted from the above-mentioned investment manager registration requirement by outsourcing all the investment management activities to an investment manager who has investment management business registration under the FIEA, subject to certain additional requirements. These requirements include the filing of a notification by the investment manager, and certain limited information concerning the LPS fund and its general partner must be included in the notification.

iii Private placement rule

For an offering of interests in an LPS fund that invests more than 50 per cent of its contributed funds in securities or derivatives, a public offering process (which includes the filing of a securities registration statement) must be followed unless the private placement requirements under the FIEA are satisfied. The private placement requirements for interests in partnerships mandate that fewer than 500 investors in Japan should acquire and hold the interests of the partnership as a result of an offering. As long as fewer than 500 investors in Japan ultimately acquire the interests as a result of the offer, the number of offerees may be 500 or more. In the case of private placement of securities, the general partner (or a third party conducting the solicitation) must notify the investors in writing that the offering meets the requirements for a private placement of the LPS fund interests and, accordingly, is not being registered under the FIEA, and that the LPS fund interests fall under a certain right provided in a certain provision of the FIEA (‘the rights set forth in Article 2, Paragraph 2, Item 6 of the FIEA’, in the case of interests in foreign LPS funds). This document must be delivered to the investor concurrently with or prior to the investor's acquisition of the LPS fund interests.

iv Use of a JLPS

The Ministry of Economy, Trade and Industry (METI) has published on its website a model limited partnership agreement for a JLPS. According to METI, the model limited partnership agreement was prepared based on its research of terms contained in both onshore and offshore limited partnership agreements, and with an objective of having the key terms of the model
limited partnership agreement be consistent with those found in similar agreements used in other jurisdictions. In light of the existence of this model limited partnership agreement for a JLPS, Japan-based general partners who choose to use JLPSs tend to use this model agreement as the basis for preparing their limited partnership agreements, but experienced fund sponsors tend not to rely so much on the model agreement. Also, the most recent version of the model limited partnership agreement for a JLPS is intended to be a model for venture capital funds to be formed in Japan, and the sample terms in the model limited partnership agreement would have to be carefully reviewed and modified depending on the type of the fund. Moreover, there is an increasing trend to use offshore limited partnerships as an alternative fund vehicle for investments by non-Japanese investors, and when this parallel fund structure is employed, the terms regarding the JLPS tend to be adjusted to substantially match the terms regarding the parallel fund. Non-Japanese fund operators do not usually use a JLPS as a fund vehicle for investors in Japan, but rather utilise non-Japanese limited partnerships as fund vehicles for offerings to investors in Japan.

III REGULATORY DEVELOPMENTS

In response to the rising number of incidents that led the Japanese regulatory authority to conclude that the QII special business exemption did not provide sufficient protections for some investors, the Diet substantially amended the regulations addressing the QII special business exemption. Under the amendment that came into effect in 2016, the qualifications and requirements imposed on fund operators engaging in solicitation of investors or management of fund assets under the QII special business exemption (such as businesses covered under the QII special business exemption, i.e., specially permitted businesses) were significantly strengthened. Many of the compliance requirements, such as adherence to certain code-of-conduct rules, record-keeping requirements and public disclosure requirements that were previously only applicable to firms with Type II registration or investment manager registration status became applicable to fund operators engaging in a specially permitted business.

1 Requirements for the QII special business exemption

For a general partner to qualify for the QII special business exemption, in addition to other requirements, the LPS fund must meet the criteria stipulated in items (a) to (f) below (although the criteria set out at (e) and (f) only apply if the general partner is seeking exemption from the Type II registration requirements):

- at least one of the investors in Japan, other than the general partner, is a QII;
- the number of non-QII investors in the fund in Japan is 49 or fewer;
- the non-QII investors satisfy certain criteria (non-QII investors that satisfy these criteria are termed ‘qualified purchasers’);
- in the case of certain fund of funds, subject to certain exceptions (such as where a sub-fund is a limited partnership and the total number of non-QII investors in Japan in the fund and the sub-fund is 49 or fewer), no non-QII investor is an investor in any of the sub-funds of the fund;
- the offering of the LPS fund interests qualifies as a private placement; and
- the limited partnership agreement or the subscription agreement provides that (1) if an investor is a QII, it may not transfer any interest to a non-QII, and (2) if an investor is
a non-QII, it may only transfer interests to a qualified purchaser or a QII, and may not transfer interests to any other person unless it transfers all its interests at once to that person in a single transfer.

Even where the private equity fund vehicle is an employee fund or a general partner carry vehicle, if any of the officers or employees investing in the vehicle are based in Japan, the fund vehicle must be eligible for the QII special business exemption.

ii Disqualifying certain fund operators

Additionally, to qualify for and benefit from the QII special business exemption, certain criteria apply for fund operators (i.e., the general partner in the case of a limited partnership); for example, if the only QII investing in the fund is a JLPS, the fund operator of that fund will not be able to qualify for the QII special business exemption unless the JLPS satisfies a certain asset value threshold requirement. In addition, a fund operator will not be able to take advantage of the QII special business exemption if 50 per cent or more of the capital contribution in the LPS fund is made by investors who have close relationships (as defined in the FIEA) with the fund operator (with certain exceptions). Based on this rule, certain employee funds or carry vehicles may be disqualified from the QII special business exemption.

iii Disqualifying certain non-QIIs

Investors that may invest in a particular fund qualifying for QII special business exemption are limited to QIIs and 49 or fewer qualified purchasers, provided certain other criteria are satisfied. Qualified purchasers are specifically listed in the applicable regulation, and include, among others, the following:

a financial instruments business operators registered under the FIEA;

b those having a close relationship with the relevant fund operator;

c listed companies;

d corporations whose net asset value or capital is at least ¥50 million;

e subsidiaries or affiliates of (a), (c) or (d) above;

f domestic pension funds and foreign pension funds with investment-oriented financial assets totaling ¥10 billion or more;

g foreign entities;

h individuals with investment-oriented financial assets totaling ¥100 million or more and who have held a securities account for more than one year;

i corporation with investment-oriented financial assets totaling ¥100 million or more;

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4 ‘Those having close relationship with the relevant fund operator’ include, among others: directors and employees of the fund operator; the parent, subsidiary and brother or sister companies of the fund operator; the investment adviser or manager of the relevant fund; and the directors and employees of the parent, subsidiary or brother or sister companies of the fund operator or investment adviser or manager of the fund.

5 ‘Investment-oriented financial assets’ include instruments such as securities, derivatives and derivative deposits, but do not include cash, ordinary deposits and real estate.

6 Ibid.

7 Ibid.
j general partners of partnerships who hold investment-oriented financial assets totalling ¥100 million or more; and

k foreign funds in the form of partnerships.

iv Filing of an Article 63 Notification

The general partner of an LPS fund who wishes to engage in a specially permitted business and to qualify for the QII special business exemption is required to file an Article 63 Notification (or Form 20) prior to accepting subscriptions from investors in Japan. The Article 63 Notification may be prepared in English and must include certain information concerning the general partner, such as its name, the amount of its stated capital, the names of its officers and certain key employees, and the location of its principal office (also, if the business operation is delegated to a third party, information concerning the third party is to be provided) and, in the case of a foreign fund operator, the name of its representative or agent in Japan. The Article 63 Notification must also include the name of the fund, a brief description of the investments made by the fund and the number, names and types of all the QIIs investing in the LPS fund. This notification must be updated on an ongoing basis if there is any change to the information contained in the notification.

A foreign fund operator must appoint a representative or agent in Japan in advance of the filing. The designated representative or agent in Japan will be the authorised contact person for the foreign fund operator if the Japanese regulators wish to contact the foreign fund operator. In addition, as noted below, a general partner who files the Article 63 Notification is subject to certain public disclosure requirements, and foreign fund operators without an office in Japan are expected to make the necessary public disclosures on a website. The address of the web page where the public disclosures are to be made must also be included in the Article 63 Notification filed by any such foreign fund operator.

v Application of certain code-of-conduct rules under the FIEA

Certain codes of conduct rules that apply to firms with Type II registration or investment manager registration status are applicable to fund operators who filed the Article 63 Notification. Some of the code-of-conduct rules applicable to fund operators include: duty of good faith, prohibition on name lending, regulations on advertising, etc., delivery of document prior to conclusion of contract, delivery of document upon conclusion of contract, etc., prohibition on providing false information, prohibition on providing conclusive evaluations, prohibition on providing special benefits, prohibition on loss compensation, principle of suitability, segregation of assets, and prohibition on offerings, etc. when the fund operator uses the fund assets for other purposes.

Some of the codes of conduct rules that are only applicable to investment management of fund assets include: duty of loyalty and duty of prudent manager, prohibition on trading with itself, prohibition on trading between assets managed by itself, prohibition on loss compensation, segregation of assets, and preparation and provision of investment report.

Some additional notes regarding the prohibitions or requirements are set out below.

Segregation of assets

The requirements for segregation of assets that apply to offering of interests and investment management of fund’s assets are different. The requirements for segregation of assets that apply to offering of interests focuses on segregation of cash and must be expressly stated in the
partnership agreement or other fund-related agreement (such as the subscription agreement). The segregation of assets that apply to fund operators with respect to the investment management of fund’s assets applies not only to cash but also to securities in the fund assets.

**Professional investor and non-professional investor**

Fund operators must confirm whether an investor is a QII or a non-QII, and if the investor is a non-QII who is a qualified purchaser, they must further confirm whether the investor is a professional or non-professional investor. A professional investor as defined in the FIEA includes, among other things, a QII, a listed company, a Japanese kabushiki kaisha (a joint-stock company, as defined under the Companies Act of Japan) whose capital is reasonably anticipated to be ¥500 million or above, a financial instruments business operator registered under the FIEA, a legal entity that has filed the Article 63 Notification, and a foreign entity. In addition, the fund operator must notify each professional investor that is not a QII that investors may choose to be treated as non-professional investors. Certain code-of-conduct rules (such as regulations on advertising, the requirement to deliver certain documents prior to the conclusion of a contract, the requirement to deliver certain documents upon the conclusion of a contract, etc., the principle of suitability, and the requirement to deliver a statutory performance report) do not apply in relation to an investor who is a professional investor.

**Record-keeping obligations**

Fund operators who have filed the Article 63 Notification are required to prepare and maintain certain books and records that include matters required under the FIEA and its subordinated regulations. These include customer ledgers, transaction records and copies of certain statutory documents.

**Annual business report filing requirement**

Each fund operator who has filed the Article 63 Notification must file a business report (Form 21-2) for each fiscal year, within three months of the end of the fiscal year. The annual business report may be prepared and filed in English and must include the financial statement of the fund operator. Please see below for the public disclosure requirement of certain matters included in the business report.

**Public disclosure requirements**

A fund operator who has filed the Article 63 Notification is subject to two different public disclosure requirements: (1) one requiring the fund operator to disclose certain information included in Article 63 Notification, and (2) the other requiring the fund operator to disclose an explanatory document, which is a document that contains certain (but not all) information included in the annual business report.

**Public disclosure of matters included in the Article 63 Notification**

Matters included in the Article 63 Notification other than the names of the QIIs and the identity of the representative or agent in Japan of a foreign fund operator must be disclosed to the public by making them available at the fund operator’s principal place of business and at all the offices that engage in the specially permitted business, or on the website of the fund operator. If the fund operator does not have any office or place of business in Japan,
the fund operator must make the disclosure on a web page or through other means that can be easily accessed by investors in Japan. The responsibility for making of this public disclosure can be delegated by the fund operator but the fund operator must take appropriate measures to ensure that investors can easily find where the public disclosure is made. This public disclosure may be made in English.

**Public disclosure of the explanatory document**

The fund operator is required to prepare an explanatory document (Form 21-3) that includes certain information included in the annual business report, and disclose the explanatory document to the public by making it available at its principal place of business and at all offices that engage in the specially permitted business, or on the website of the fund operator. The financial statement of the fund operator that is attached to the annual business report is also a part of the explanatory document and must be publicly disclosed. The timing and method by which a foreign fund operator is to make such a disclosure are the same as those for the public disclosure of matters included in the Article 63 Notification. The explanatory document may be prepared in English.

**Increased oversight and enforcement by the regulator**

Under the FIEA, the Japanese regulator is vested with enhanced oversight authority over fund operators. For example, the regulator may issue an administrative order against a fund operator ordering the operator to improve, suspend or discontinue its business operations with respect to a specially permitted business, and the regulator may instruct the fund operator to submit reports or allow the regulator or its designee to conduct on-site inspections when it deems necessary to protect the interests of investors. In addition, the amendments that came into effect in 2016 introduced more severe penalties to be imposed on fund operators who fail to make the required notifications or who file false notifications.

**IV OUTLOOK**

The regulatory environment for fund operators without Type II registration or investment manager registration status changed substantially in 2016 following the amendments to the FIEA concerning the QII special business exemption. We see more and more foreign fund operators choosing to benefit from the foreign fund exemption so that maintenance of Article 63 Notification is not required after fundraising is completed, thus avoiding both public disclosure of the explanatory document and having to comply with various compliance requirements under the FIEA. Although Japanese regulators have been actively conducting on-site inspections of fund operators that have problematic operations, the extent to which regulators are likely to actually require and conduct on-site inspections of fund operators generally is still not clear.

Fund operators intending to benefit from the QII special business exemption should carefully consider whether they can comply with the applicable Japanese regulations and should also carefully examine whether other exemptions from registration requirements available under Japanese law may apply, prior to filing the Article 63 Notification. We expect that more fund operators who have filed the Article 63 Notification will be keen to submit a notification to discontinue their specially permitted businesses where possible.
I GENERAL OVERVIEW

Regulations on onshore private equity (PE) funds were first introduced in Korea in 2004 following the enactment of the Indirect Investment Asset Management Business Act (MMIIAA). In 2009, the MIIAA 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 Korea. Since 2004, there has been a remarkable growth in the Korean PE fund market and the number of PE funds in Korea has increased from two in 2004 to 444 as at the end of 2017.

During the early years after the introduction of PE funds in 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 comprise more than 70 per cent of all PE funds registered with the Financial Services Commission (FSC).

During previous years, financial institutions such as banks, securities companies and asset management companies, have acted as general partners; however, the number of institutions acting solely as general partners has increased and, as a result, they now comprise 66 per cent of the total number of GPs in Korea.

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1 Chris Chang-Hyun Song, Tae-Yong Seo, Joon Hyug Chung, Sang-Yeon Eom are partners and Seung Hyun Dennis Cho is a foreign legal consultant at Shin & Kim.

2 A new technology business investment partnership prescribed in the Specialized Credit Finance Business Act, a small or medium-sized enterprise establishment investment partnership prescribed in the Support for Small and Medium Enterprise Establishment Act and a new technology venture investment partnership prescribed in the Act on Special Measures for the Promotion of Venture Businesses are similar to a venture capital fund as understood in the United States and Europe, and can be considered a private equity fund in a broader sense. For the purpose of this article, we discuss the private equity funds governed by the FSCMA.
The first table below indicates the number of registered PE funds in Korea and the second table sets out the total commitment amounts and total invested amounts in recent years.³

<table>
<thead>
<tr>
<th>Year</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of funds</td>
<td>181</td>
<td>226</td>
<td>237</td>
<td>277</td>
<td>316</td>
<td>383</td>
<td>444</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total commitment amount (A) (x100 million won)</td>
<td>318,859</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>
</tr>
<tr>
<td>Total invested amount (B) (x100 million won)</td>
<td>176,978</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>
</tr>
<tr>
<td>Investment ratio (B/A)</td>
<td>55.5%</td>
<td>52.7%</td>
<td>63.8%</td>
<td>62%</td>
<td>65.6%</td>
<td>70.1%</td>
<td>72.7%</td>
</tr>
</tbody>
</table>

The table below sets out the number of PE funds, sorted by volume of commitment amounts.

<table>
<thead>
<tr>
<th>Year</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large (commitment of 300 billion won or above)</td>
<td>36</td>
<td>45</td>
<td>47</td>
<td>51</td>
<td>57</td>
<td>53</td>
<td>48</td>
</tr>
<tr>
<td>Medium-sized (commitment of 100 billion–300 billion won)</td>
<td>50</td>
<td>63</td>
<td>76</td>
<td>100</td>
<td>115</td>
<td>127</td>
<td>130</td>
</tr>
<tr>
<td>Small (commitment of 100 billion won or lower)</td>
<td>95</td>
<td>118</td>
<td>114</td>
<td>126</td>
<td>144</td>
<td>203</td>
<td>266</td>
</tr>
<tr>
<td>Total</td>
<td>181</td>
<td>226</td>
<td>237</td>
<td>277</td>
<td>316</td>
<td>383</td>
<td>444</td>
</tr>
</tbody>
</table>

The table below indicates the number of institutions acting solely as general partners (Independent GPs) and the number of financial institutions participating as general partners (FI GPs).

<table>
<thead>
<tr>
<th>Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent GPs</td>
<td>82 (50.6%)</td>
<td>94 (56.3%)</td>
<td>115 (60.5%)</td>
<td>138 (66.0%)</td>
</tr>
<tr>
<td>FI GPs</td>
<td>80 (49.6%)</td>
<td>73 (43.7%)</td>
<td>75 (39.5%)</td>
<td>71 (34.0%)</td>
</tr>
<tr>
<td>Total</td>
<td>162 (100%)</td>
<td>167 (100%)</td>
<td>190 (100%)</td>
<td>209 (100%)</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 funds (hedge funds) and management participation private funds (known as PEFs) – into a single regime, and as such, we expect fundamental changes to the regulation and operation of the PE fund market in Korea. The major changes to the FSCMA announced by the FSC are discussed in detail in Section III.

II  LEGAL FRAMEWORK FOR FUNDRAISING

i  Incorporation of a PE fund

The legal form of a PE fund in 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 general partner (GP) with unlimited liability and one limited partner with limited liability. In practice, nearly all GPs act as the managing partner of the PE fund.

The qualification requirements for an LP are as follows: (1) professional investors, as defined in the Enforcement Decree of the FSCMA (mostly financial institutions and pension funds), or (2) individuals, corporations or other organisations investing 300 million won or more (however, 100 million won for an executive officer of a GP or a fund manager) in a PE fund. As a PE fund is also categorised as a private placement fund, 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 GP

When the PE fund regime was first introduced in 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 Korea. To register as a GP, the following conditions must be satisfied.

a  minimum capital of 100 million won or more;
b  compliance of each executive officer of the GP with Article 5 of the Act on Corporate Governance of Financial Companies;
c  employment of a minimum of two individual fund managers;
d  establishment of an internal compliance policy to identify, assess and manage the possibility of conflicts of interest; and
e  maintenance of sound financial standing and social credibility as prescribed in the Enforcement Decree of the FSCMA.

iii  PE fund asset management method

The asset classes that a Korean PE fund is permitted to acquire are narrow. The FSCMA requires PE funds to operate such that it participates in the management of its portfolio companies. In this regard, the FSCMA requires a PE fund to manage its assets strictly 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;5

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4 In practice, however, at least two LPs are required, as a PE fund is subject to dissolution if the number of LPs is fewer than two. This does not apply in the case when a pension fund becomes the sole LP of a PE fund.

5 In practice, retaining a right to appoint one or more directors of the target company is deemed as exercising 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 (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 rate;

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.

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 paragraphs (a), (b), (c) or (f) above;

a PE fund must retain the securities acquired in the manner stipulated in paragraphs (a), (b) or (c) above for at least six months and must not dispose of them within the six-month period;

a PE fund is not allowed to make investment in the shares of a foreign corporation if 30 per cent or more of the assets held by the foreign corporation and its subsidiaries (out of their total assets) are located in Korea; and

a PE fund is permitted to incur an indebtedness if (1) it is the unavoidable result of 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 does not exceed 10 per cent of the net assets of the PE fund.

If a PE fund enters into a transaction where the PE fund is permitted to exercise a put option for its shares in a target company at an exercise price calculated on the basis of the PE fund’s internal rate of return (IRR) during the investment period, on the 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 such an investment by the PE fund in the target company can be interpreted as a de facto loan and, further, that it is in violation of the PE fund asset management method prescribed under the FSCMA.

Since the first introduction of the PE fund regime in 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, the PE fund 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 a special purpose company

The FSCMA allows an investment by a PE fund by way of incorporating a special purpose company (SPC). The requirements for establishing and operating an SPC are as follows:

- **a** the SPC must be a joint-stock company or a limited company pursuant to the KCC;
- **b** the SPC must be in compliance with the PE fund asset management method provisions of the FSCMA;
- **c** a shareholder or a member of the SPC must be the PE fund, an executive officer of the target company, the major shareholder or a person designated by the Enforcement Decree of the FSCMA, provided that the PE fund’s shareholding ratio in the SPC is 50 per cent or greater;
- **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 must be 49 or fewer; and
- **e** the SPC must not employ a full-time executive officer or staff and nor maintain a place of business other than a head office.

An SPC may borrow an amount of up to 300 per cent of its net assets and, therefore, a PE fund may make a leveraged investment in a target company by incorporating an SPC.

v Monitoring of PE funds by regulators

In Korea, the FSC and the Financial Supervisory Service (FSS), the executive body of the FSC, oversee PE funds and the GPs managing PE funds. If an onshore PE fund or a GP violates the relevant laws, the FSC has the power to take the following measures:

- **a** cancel the PE fund’s registration;
- **b** suspend all or part of the fund’s business;
- **c** demand that the Korean PE fund dismiss, suspend from duty, issue a warning to or admonition against its officers;
- **d** issue a warning to or admonition against the private equity fund;
- **e** demand that the Korean PE fund dismiss, suspend from duty, reduce salaries, reprimand, or issue warnings or admonitions against its employees; or
- **f** issue a remedial order or demand certain measures for compensation of damage incurred by the PE fund’s 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 for 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 PE fund.
A PE fund is not allowed to make investments in the shares of a foreign corporation if 30 per cent or more of the assets held by the corporation and its subsidiaries (out of their total assets) are located in Korea. The threshold rate used to be 5 per cent.

Previously, a PE fund was prohibited from incorporating multiple layers of SPCs (i.e. having its first SPC incorporate a second SPC, and so on). This is no longer applicable and a PE fund may have multiple layers of SPCs.

A strategic investor can become a member of an SPC. Previously, only a PE fund, an executive officer or the major shareholder of a target company could become a member of an SPC.

At the end of 2016, the amendment to the FSCMA introduced PE funds specifically designed for investing in start-up companies and venture companies (the Start-up and Venture PE fund). Start-up and Venture PE funds enjoy certain corporate tax benefits if they invest 50 per cent or more of their assets in a venture business or a technology and innovation-driven small or medium-sized enterprise within two years of the fund’s incorporation.

Under the current FSCMA, private placement funds in Korea can only be categorised as either a hedge fund or a PE fund, and these can be largely distinguished as follows.

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. Furthermore, the PE fund must acquire shares with 10 per cent or more of the voting rights through its investment (alternatively, the PE fund can be granted the right to appoint one or more director of the target company as a condition of its investment), whereas, in contrast, 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.

A hedge fund is allowed to incur an indebtedness up to the amount of 400 per cent of its net assets, whereas a PE fund is generally prohibited from incurring an indebtedness (aside from a few exceptions), but if the PE fund is making an investment via an SPC, it may leverage its investments up to the amount of 300 per cent of the net assets of the SPC.

There are stricter requirements for hedge fund managers in terms of capital requirements, for professional managers and for major shareholders when compared with those of PE funds.

In September 2018, the FSC announced that there will be an amendment to the FSCMA to reform the private placement fund scheme in Korea. Under the newly amended FSCMA, the FSC will only allow a single type of private placement fund, which will integrate the hedge fund and the PE fund schemes. According to the FSC’s statement, the major changes will be as follows.

The new integrated private placement fund (the Integrated Fund) will be able to invest in shares, loans, derivatives or real estate assets. In particular, in relation to securities investment, there will no longer be any minimum or maximum limitation on the shareholding in a portfolio company.

The Integrated Fund will be permitted to incur indebtedness of an amount up to 400 per cent of its net assets.

An Integrated Fund fund manager will be required to comply with the current requirements for hedge fund managers.
Existing PE fund GPs that cannot comply with current hedge fund manager requirements will be able to manage an Integrated Fund in which only institutional investors (as prescribed in the FSCMA) participate as LPs.

Previously, the standard for distinguishing a public offering fund from a private placement fund was whether a solicitation or offer was made to 50 or more parties, whereas under the newly amended FSCMA the standard will require 50 or more parties to have actually accepted the offer.

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 Korea. In particular, there has been a remarkable expansion in the market in the past decade and, in fact, PE funds have been leading Korea’s M&A sector for many years. It is expected that the Korean PE fund market will continue to grow in the near future while large pension funds such as the NPS continue to play the role of anchor investor to large PE funds.

One of the current features of Korea’s PE fund market is that secondary PE funds are not yet very active compared with activity in seasoned PE markets such as the United States and the EU. 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.

Also, it is expected that the private placement fund market will grow rapidly once the proposed amendment to the FSCMA expands the scope of the investment method and asset classes applicable to PE funds, and relaxes the standard for being recognised as a ‘private placement’ fund. Existing GPs will have to decide whether to increase their capital, and professional manpower, to continue their business as a fund manager of an Integrated Fund under the new regime, or to maintain their current capital volume and manpower, and maintain their status as fund managers for private placement funds for institutional investors.
I GENERAL OVERVIEW

The Luxembourg asset management industry had another stellar year in 2018. 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 2017 and December 2018, the number of RAIFs increased from 294 to 561.

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 SPVs 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

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Luxembourg

1. Creation of the RAIF
   - 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.

2. 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.

### 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 2017, over 1,300 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), it is to be expected that securitisation funds, which are not corporate income taxpayers, will gain 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.

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 have 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 the light of the imminent implementation (i.e., before 1 January 2020) into Luxembourg tax law of the second EU Anti-Tax Avoidance Directive (ATAD 2).3

ATAD 2 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 ATAD 2. 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. Furthermore, on account of its tax transparency, the hybridity of the financial instrument would have to be analysed on a look-through basis at the level of the limited partners.

These rules will only apply between related or associated parties or in the context of a structured arrangement. An investor will be considered an associated entity in relation to the underlying Luxembourg company 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. With respect to this threshold requirement, ATAD 2 makes reference to the OECD concept of ‘persons acting together’ without providing any further clarification. However, reference to this concept could mean that investors investing through a tax-transparent partnership would have to be considered parties related to the underlying Luxembourg company, as their respective interests would have to be aggregated for the purpose of the calculation of the 50 per cent or 25 per cent threshold (with their interest being managed by the same person, i.e., the fund or the fund manager).

Finally, while ATAD 2 also sets out a ‘reverse hybrid mismatches’ rule, this will only have to be implemented before 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 in its country of residence as a result of its hybridity. For this rule to apply, non-resident investors would have to hold at least 50 per cent of the entity’s interest. It is not clear whether the persons-acting-together concept would apply for the calculation of this threshold. In particular, it could be reasonably argued that investors of an LP are not expected to act together with the other investors with respect to their interest in the fund itself. Moreover, ATAD 2 sets out a specific carve-out from this rule for collective investment vehicles, and clarification will be required as to whether alternative investment funds should also benefit from the carve-out.

In light of ATAD 2, it may therefore become preferable in the future to choose a tax-opaque vehicle, such as a RAIF-SCA, to avoid negative tax consequences at the level
of the underlying Luxembourg company held by the fund (if any) or at the level of the fund itself, once the reverse hybrid mismatches rule becomes effective. Asset managers should carefully consider the impact of ATAD 2 on their existing fund structures.

IV OUTLOOK

Brexit is likely to be one of the main challenges for the European private equity industry for the next few years. At the time of writing, uncertainty remains as to the ultimate agreement that will govern relations between the United Kingdom and the European Union once Brexit becomes a reality. Many private equity houses are currently basing their Brexit strategy on the worst-case scenario, one involving a cliff-edge exit from the single market by the United Kingdom. In such a scenario, all UK fund managers would lose overnight the benefits of all 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 in 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, 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 14

MEXICO

Hans P Goebel C, Héctor Arangua L, Adalberto Valadez and Miguel A González J

I GENERAL OVERVIEW

Over the past 18 years, Mexico’s private equity (PE) industry has raised over US$56 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 has reached 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.

In 2015, Mexico outpaced Brazil to become the most popular destination country for private equity vehicles in Latin America. According to the Emerging Market Private Equity Association (EMPEA), Mexican dedicated private equity vehicles went from raising a modest US$152 million in 2008 to US$2.1 billion in 2015. While a decrease has been recorded over the past two years, in terms of capital deployed, Mexico is still placed second, behind Brazil, and accounted for 22 per cent of investment in the region, according to the Latin American Private Equity and Venture Capital Association (LAVCA).

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 (ALADI); 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 seventh-largest car manufacturer in the world, with the third-largest growth in exports within the automotive industry. Mexico actively participates

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4 Idem.
6 Secretariat of Economy of Mexico.
in multilateral and regional organisations and forums, such as the World Trade Organization, the Asia-Pacific Economic Cooperation, the Organisation for Economic Cooperation 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 than US$885 million in more than 84 funds and co-invested in 17 deals. In addition, the National Institute of Entrepreneurship has helped the Mexican venture capital (VC) industry and seed capital ecosystem, by investing or co-investing in 41 funds from 2013 to 2016. For 2016 the VC support changed 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.

The Mexican economy performed better than expected during 2018, with annual gross domestic product (GDP) growth of 2.3 per cent, despite the victory of leftist López Obrador in the presidential elections and the announcement of the cancellation of the construction of the New International Airport for Mexico City, currently the most important infrastructure project in Mexico. Notwithstanding the above, Mexico is placed as the second-largest economy in Latin America (with an estimated GDP of US$1.14 trillion). Mexico is considered to have economic stability, with conservative but still-rising growth rates. The Mexican economy has been growing at an average 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. However, policy uncertainty and the continuing prospect of subdued investment are expected to keep growth at a moderate 2 per cent in 2019, despite the decrease in trade-related uncertainty following the announcement of the United States–Mexico–Canada Agreement signed on 30 November 2018. The World Bank suggests Mexico might be the seventh-largest economy by 2050 – a positive outlook that will only serve to attract direct foreign investment.

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 six 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.13 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.14

Likewise, accumulated capital commitments from 2017 to September 2018 increased 2.2 per cent (US$37 million); more than half of last year’s fundraising activity took place in the closing quarter of the year. In addition, these capital commitments were mainly concentrated on the first VC funds.15 As at September 2018, six new Mexican funds had been formed, bringing the number of funds operating in Mexico to 118, of which 63 per cent are specific to seed capital stages.16

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, since 2014, been in an upward trend. In the past years 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 larger 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. The Mexican fintech industry has shown an annual growth rate of 40 per cent, with a particular increase in the retail, technologies, trading and capital markets sectors.17 Recent reports have highlighted the high growth rates of fintech in Latin America, such as LAVCA’s ‘2017 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. Moreover, according to ‘Fintech Radar Mexico’, conducted by Finnovista in August 2018,18 238 Mexican fintech start-ups have been identified across 11 different segments, which represents a growth in the number of fintech start-ups of 50 per cent since August 2016; in only a year more than 100 new fintech start-ups have been created, which positions Mexico as the second-largest fintech hub in Latin America, in part because of a strong presence of entrepreneurship and e-commerce. In 2017 alone, a total of US$62.9 million was invested in 15 start-ups from

14 Ibid.
16 Ibid.
18 Ibid.
the fintech industry (such as Abra, a mobile money start-up that uses the technology behind bitcoin, and Pangea Money Transfer, an app-based cash transfer service targeted at the US$25 billion Mexicans in the United States send home every year) and all these start-ups were invested in by Monterrey-based Ignia. 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.\textsuperscript{19} Mexico’s VC sector is now an attractive market in which to invest, with 63 active Mexico-based fund managers and 50 foreign GPs who performed at least one transaction in the past four years. In the same vein, AMEXCAP registered 973 VC transactions for a total of more than US$1 billion invested from 2009 to September 2018 and, on the liquidity side, noted 13 exits during 2018. The growth seen in 2016 remains the industry record, with the largest number of transactions and representing US$209 million of capital invested.

In the past 18 years, foreign funds have only contributed approximately 10 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 Electric 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 2018, there are more than 25 CKDs investing in the infrastructure and energy sectors, which have raised over 123 billion pesos.\textsuperscript{20}

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. 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.

\textsuperscript{19} AMEXCAP, ‘Overview of the Venture Capital Industry in Mexico, October 2017’.
\textsuperscript{20} Ibid.
promoting a significant inflow of outside capital and creating an estimated 2 million jobs by 2025.\textsuperscript{21} The oil and gas sector is becoming a top sector: almost half the transactions made were in this sector (nearly US$6 billion invested in recent years).

Furthermore, 2018 was a strong year 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.\textsuperscript{22} Private investment into Mexico’s energy infrastructure industry will experience strong growth as the energy reform’s measures continue to take hold; many other opportunities will also arise regarding electricity production projects (mainly combined-cycle gas plants and renewables) for both general and private consumption. In addition, Mexico is committed to honour 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.\textsuperscript{23}

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,\textsuperscript{24} 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 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 (IMG) 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

\textsuperscript{21} Rosenfel E, ‘Mexico to receive major economic jolt’, CNBC.com, 2014.
\textsuperscript{24} AMEXCAP, ‘Inside Mexico’s PE Market: November 2017’.
users in the state of Quintana Roo.\footnote{ENGIE: https://www.engiemexico.com/#/EngieMexicoServicios/?seccion=transporte-gas-natural-ENGIE-mexico.} 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.\footnote{Pemex: http://www.pemex.com/saladeprensa/boletines_nacionales/Paginas/2017-064-nacional.aspx.} 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 2018, more than 100 contracts have been awarded to 75 international firms or consortiums, from 20 countries, during the Round 1 bids.\footnote{Comisión Nacional de Hidrocarburos (7 December 2018): https://rondasmexico.gob.mx/esp/cifras-relevantes/.}

Industries are changing and Mexico’s global competitiveness is increasing as reforms and governmental initiatives modify the structure of the economy to attract investments. 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.\footnote{PRO México: www.promexico.gob.mx/es/mx/queretaro.} On the occasion of Mexico’s Aerospace Summit 2018, it was announced that the aerospace industry has grown from 100 American and European producers in 2004 to more than 340 in 2018.

The Mexican PE market has grown considerably over the past 18 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.\footnote{‘Private Equity in Mexico: Primed for significant growth’, Antonio Martinez Leal and Pino del Sesto, Bain and Company.} 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 case during 2015 and 2016.

In connection with the foregoing, Mexico’s government introduced in 2015 two new investment instruments to promote Mexico’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 in the Mexican Stock Exchange 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 2018 to make the instrument more appealing.

In December 2015, the investment project certificates or CERPIs were introduced. CERPIs will 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 the GPs and lower investment requirements for the 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 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 access a portion of the billions of dollars managed by the AFOREs that can be invested in this type of security. There are approximately 14 CKDs in the pipeline pending approval, which would capture around US$4 billion. On average, nine CKDs per year have been listed since 2010.

The same timeline applies for Mexican FIBRAs that raise capital through the issuance of real estate certificates, which are generally publicly offered in the BMV stock exchange 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 who, 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 June 2018, IGS Group signed a purchase agreement for the portfolio of La Frontera, including 37 industrial warehouses, for a total of US$117 million. The transaction is still subject to approval by the antitrust authority, the Federal Economic Competition Commission.30

In June 2018, Delta held the issuance and placement of a CKD for a maximum amount of 4 billion pesos on the BMV. This CKD will invest in real estate and urban developments.

In September 2018, IDK capital announced a first closing for 1.05 billion pesos with private investors, this amount will help the fund to continue with its strategy of investing in infrastructure projects, including in water, transportation, health and civil infrastructure.31

In November 2018, ALLVP had the first closing of its US$100 million Fund III for US$73 million.32

In November 2018, O’Donnell Group held the issuance and placement of a CKD for a maximum of 2 billion pesos on the BMV. The fund will invest in industrial and urban real estate and in the development of industrial logistic infrastructure.33

In November 2018, Discovery Americas, through its vehicle DAIIV, entered into an investment with one of the leading actors in the air cargo industry in Mexico, Mas Air, which is a cargo airline specialising in the transportation of freight.34

During 2018, IGNIA, Dalus Capital and Innocells led US$6.5 million investment in the online platform UnDosTres, a fintech digital payments platform that aims to provide secure financial services while reducing inefficiencies for consumers.35

II LEGAL FRAMEWORK FOR FUNDRAISING

The Canadian limited partnership is one of the most popular legal forms for structuring PE funds with Mexican LPs’ investment, as they are considered transparent for tax purposes. 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 which 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

32 AMEXCAP: https://en.amexcap.com/content/all-in-latin-america-allvp-raises-a-fresh-100-m-fund.
35 LAVCA: https://lavca.org/IGNIA+%26+Dalus+Capital+Lead+US%246.5m+Investment+in+Online+Payment+Platform+UnDosTres.
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 CKDs and FIBRAs 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.

As explained above, 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 above).

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.

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 which 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.

\(f\) 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.

\(g\) 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 the 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 15

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 2017. 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, 2017 saw the low total of 0.9 billion kroner, over half of which was made up of mid-cap manager Norvestor’s seventh fund. Illustrating the volatility between different vintage years, 2016 saw record high fundraisings, amounting to 22 billion kroner. The figure for 2007 was 4.8 billion kroner. In December 2017, healthcare specialist and newcomer Hadean Ventures closed its first fund, Hadean Capital I, with a target cap of €100 million.

With such a low total for 2017, there was only one significant fundraising that year – that of Norvestor VII. For Norway, 2018 also seems to have ended with a low total for fundraising by private equity funds, although some larger fundraisings are expected for 2019.

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

1 Peter Hammerich is a partner and Markus Heistad is a senior lawyer at BAHR.
2 Source: Argentum.
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 2017 activity report.
5 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. As of 1 January 2019, Norwegian pension funds are 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 AIF Act. Although it is expected that the EU-regulated fund types European Venture Capital Funds (EuVECaS), European Social Entrepreneurship Funds (EuSEF) and European Long-Term Investment Funds (ELTIF) 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.

With Brexit on the horizon, several fund managers have assessed 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.

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 (MFN) 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 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 AIMD 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). 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 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 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 are 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. 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. Note, however, that 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. Distribution of private equity interests in the retail segment will 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.

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.
Registered and authorised AIFMs are equally subject to the Norwegian anti-money laundering act (transposing the EU AMLD IV into Norwegian law) and the General Data Protection Regulation (GDPR), as well as to requirements under tax reporting legislation implementing 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 below). However, any gains deriving from the fund’s qualifying equity investments (see below) 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, see below).

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 any equity investments held by the fund for a consecutive period of at least two years immediately prior to the investor’s disposal are qualifying equity investments (see below). 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 article.

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 below). However, any gains deriving from the fund’s qualifying equity investments (see below) 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 (see below). The fund may generally deduct costs to the extent that they are not acquisition or realisation costs related to qualifying equity investments (see below). 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 article.

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 as from 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 at least 90 per cent of any equity investments held by the transparent entity for a consecutive period of at least two years are qualifying equity investments.

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 2019).

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, this may lay the foundations for 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. Firstly, 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.
Secondly, 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.

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 and approved by the Norwegian parliament in June 2016. EU financial legislation passed since that time – which is significant – remains largely delayed in being incorporated into the EEA Agreement. 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.

Tellingly, the European Market Infrastructure Regulation entered into force in Norway on 1 July 2017, several years later than in the EU. Both the Capital Requirements Directive IV and MiFID II have been transposed in ‘lookalike’ fashion, as the underlying regulations have not been formally incorporated into the EEA Agreement, and the revised payment services directive, PSD II, and the Market Abuse Regulation are unlikely to be implemented before the end of 2019.

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 the amendments to EU EuVECA, EuSEF and the delegated regulation under the ELTIF Regulation. As mentioned above, 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. The consultation period was relatively short, implying that the Ministry of Finance may prioritise implementation in 2019.

Lastly, the review of the AIFM Directive is expected in 2019, 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 16

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. In the first half of 2018, GDP growth in CEE amounted to 4.2 per cent, while in Poland at the same time it reached a level of 5.2 per cent. CEE countries continue to be Europe’s strongest region for GDP growth, with an estimated growth of 4.5 per cent for 2017. The World Bank projects Poland’s 2018 economic growth at 4.2 per cent on the back of investments, and private consumption. Furthermore, the World Bank’s forecast for central Europe for 2018 and 2019 is 4.5 per cent and 3.6 per cent, respectively.

In 2017, total private equity fundraising in CEE reached €1.26 billion (a 46 per cent year-on-year increase) and private equity investment reached €3.5 billion – a new record for the region. As home to almost a quarter of the companies receiving funding, Poland remained the regional leader with 71 per cent of the CEE’s total investment value, followed by Romania, Hungary and Latvia. Investment in these four countries comprised an aggregate 96 per cent of total CEE investment value. Poland also remained the largest CEE market for exits in 2017, with 47 per cent of regional divestments by value at cost.

In 2017, CEE private equity investment measured as a percentage of the region’s GDP increased significantly, from 0.122 per cent in 2016 to 0.239 per cent in 2017, and although it remained below the European average of 0.436 per cent, Poland showed results above the CEE regional average.

CEE buyout investments rose year on year by 135 per cent to a record level of €2.8 billion in 2017. Buyout investments all across Europe increased 37 per cent year on year to €51.2 billion – the highest level since 2007. Comprising 80 per cent of the total regional

1 Marcin Olechowski is a partner, Wojciech Iwański is a senior counsel and Mateusz Blocher is an associate at Sołtysiński Kawecki & Szeląg.
3 Focus Economics, Economic Snapshot for Central & Eastern Europe, 10 January 2018.
7 Ibid.
private equity investment by value, CEE buyouts were proportionally above the wider European level of 71 per cent. The number of CEE companies receiving buyout financing decreased from 42 in 2016 to 35 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 (AIF) under the EU Alternative Investment Fund Managers Directive (AIFMD).10 ASIs are generally non-regulated investment vehicles, in the form of ‘ordinary’ commercial companies, governed by the applicable rules of the Commercial Companies Code.

In 2017, a number of secondary legal acts regulating terms of conduct were issued, dealing with, inter alia, investment funds investing in derivative instruments, setting AIF maximum exposure limits, and alternative investment company managers’ reporting obligations.

i Non-UCITS investment funds (closed-end investment funds and specialised open-end investment funds)

Polish law provides for two types of non-UCITS investment funds: closed-end investment funds (FIZs) and specialised open-end investment funds (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.

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8 Ibid.
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 offering or admitted to trading on a regulated market, or both, unless the offering or admission takes place after the purchase of the securities by the fund; and (2) 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). The distinction between publicly and non-publicly traded investment certificates is based on the number of investors to whom certificates would be offered. In principle, should there be fewer than 150 investors, non-public certificates may be issued. The certificates can be either dematerialised or issued in tangible form (subject to obligatory dematerialisation
starting from 1 July 2019 – see below), as well as in registered or bearer form. In most cases, private equity investors choose non-publicly traded, dematerialized and registered investment certificates, which affords them flexibility and eliminates additional regulatory duties.

**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, change of certificates from non-publicly into publicly traded 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 open-end investment fund 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.

As previously mentioned, 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 open-end investment fund, making this form less attractive to private equity investors.

ii Commercial companies

Polish fundraising legal framework after 2016 amendments

Recent implementation of AIFMD into the Polish law – which took place in 2016, with a transitional period that ended only in mid 2017 – significantly affected the use of commercial companies as investment vehicles. As from that time, such companies are classified as alternative investment companies (ASIs) and 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:

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<td>Limited liability companies (Sp. z o.o.)</td>
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</table>

Importantly, as confirmed in the KNF’s position dated 26 April 2017, entities (companies or partnerships) established after 4 June 2016 (the date of the entry into force of the Polish AIFMD implementation), or that at that time did not conduct a business activity consisting in the collection of assets from many investors to invest them in the interest of those investors in accordance with a specific investment policy, simply cannot ‘become’ an ASI. Instead, an ASI should be incorporated (organised) and registered from scratch with the intention of becoming an ASI. Entities that existed (and conducted such a business activity) prior to 4 June 2016 could benefit from undertaking a transitional period that permitted them to obtain ASI status.
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 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

A partnership limited by shares (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.

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 – 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 in order 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 (this applies to both FIZs and SFIOs) 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.

The 2016 changes in law substantially extended the scope of depositaries’ rights and obligations and generally strengthened the position of banks in the financial market. In the current regulatory framework depositaries are obliged not only to keep a given fund’s assets and maintain their register, but also to monitor related cash flows. Additional duties were imposed on depositaries also in respect of the assets themselves: 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 now expected to act as external compliance controllers for investment funds and are obliged to conduct regular reviews of their activity in this context. Depositaries have also been given 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.

These changes have had a significant impact on the market, with most TFIs and depositaries entering into new agreements in December 2016, to accommodate to the altered legal framework. These new agreements with depositaries were mostly based on standard contract terms for a depositary agreement developed under the auspices of the Polish Bank Association (Custodian Bank Council).

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 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;
- the KNF's authorisation for the establishment of an FIZ (with the reservation outlined below);
- 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
- 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 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 an SFIO, open-end investment funds and public FIZs requires KNF 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.

**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 ZAFI 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, as stated above, subsequent 'requalification' of a commercial company as an ASI is no longer possible.
ii Taxation

As of 1 January 2017, FIZs are no longer subject to a general corporate income tax (CIT) exemption, even though significant sources of their income are still exempt from CIT (e.g., dividends payable by capital companies). 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 change will strongly affect FIZs involved in 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.

Recent changes in CIT applicable to FIZs are equally applicable 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, as of 1 January 2019, ASIs’ income derived from the sale of shares in a company is subject to 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 more than 50 per cent of whose 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, but in the first place it affected TFIs and distributors.

The regulatory changes brought about by the MiFID II implementation can be divided into three main streams: (1) limiting the 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 currently the shape of the investment market after the MiFID II implementation (see above) and the future impact of the pension reforms introducing the employee capital plans (PPKs). PPKs are a new form of additional pension saving. The new pension system will be mandatory for employing entities and (theoretically) voluntary for the employed persons. The PPK system will broadly
involve 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 will have to be dealt with by investment funds.

Also worth mentioning are the significant changes to the IFA that will take place on 1 July 2019. These changes concern the obligatory dematerialisation of certain types of securities. The recently adopted Act of 9 November 2018 amends a series of laws, including the IFA, to strengthen financial supervision and investor protection. In this respect, the new Act introduces, 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 is 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 about 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.

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See footnotes 9 and 10.

11 See footnotes 9 and 10.
Chapter 17

PORTUGAL

André Luiz Gomes, Catarina Correia da Silva and Vera Figueiredo

I GENERAL OVERVIEW

Fundraising activity in Portugal has increased significantly in recent years, in line with the
general EU trend but also capitalising on favourable 2017 gross domestic product (GDP)
growth figures, a strong export base and a relatively unexplored private equity market.

Although there are no publicly available detailed fundraising figures for 2017 or 2018,
some data points support this claim. In particular, the increase in the number of private
equity funds from 95\(^3\) in 2017 to 121 currently.

According to information available on the website of the Portuguese Securities Market
Commission (CMVM),\(^3\) there are currently 121 private equity funds, 45 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 implementation by the Portuguese Development
Finance Institution (IDF) in 2017 of the Line of Financing for Venture Capital Funds
financial instrument.\(^4\) This call for tenders is intended to select and finance venture
capital funds that will receive financial resources through this instrument from the Equity
and Quasi-Equity Fund managed by IDF. There have also been several recent successful
independent fundraisings by local private equity firms, such as Crest, Atena, Explorer and
Indico, who were able to attract international limited partners (LPs), and these have also
contributed to the increase in the number of private equity funds.

The value under management in the Portuguese private equity sector in 2017 amounted
to around €4.5 billion (2.3 per cent of GDP).\(^5\) This represents a 1.2 per cent annual growth,
which came primarily from an increase in private equity funds.

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 33.8 per cent of the total investments carried

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1 André Luiz Gomes is a partner, Catarina Correia da Silva is a counsel and Vera Figueiredo is associate
coordinator at Luiz Gomes & Associados – Sociedade de Advogados SP, RL.
esif/equity-and-quasi-equity/lineoffinancing-vcf/).
out in 2017. Although less impressive in comparison with turnaround activity, expansion operations (representing 21.5 per cent of total investments) also have an important impact because of the considerable number of operations carried out and to the amounts invested.\(^6\)

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 (19.8 per cent). In Portugal, the seed capital stage is very small, although the number of participations and amount invested has increased.\(^7\)

Private equity investment activity continues to focus on non-financial sectors, amounting to approximately half of the total investment carried out by private equity funds.

The above-mentioned data relates to 2017, as no information was available for 2018 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 and a half.

II  LEGAL FRAMEWORK FOR FUNDRAISING

The implementation of the Alternative Investment Fund Managers Directive (AIFMD)\(^8\) 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 (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.

It is important to note that 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.

The Law sets out two different legal regimes:

- 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 of more than €500 million in unleveraged assets that do not grant investors redemption rights for an initial five-year period; and

- 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 above at (b) is less stringent than that at (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;

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7 Ibid.
(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 above at (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 vehicles whenever the investment target is located primarily in Portugal.

However, 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.

Moreover, the Law sets out two new types of private equity investment vehicle that will place Portugal on a more competitive level and these are outlined below.

ii  Legal forms of private equity vehicles
The Law provides for a broad range of private equity regulated vehicles, which may be set up in several legal forms.

The Law provides for different regulated 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 vehicles are not considered to be financial intermediation activities.

As noted above, 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 (121 compared with 45).9 It should also be noted that the value of assets managed by private equity funds is much higher than the value of assets managed by private equity companies.

**Private equity vehicles outside the scope of the AIFMD**

**Private equity companies**

Private equity companies10 are limited liability companies11 incorporated with a minimum share capital of €125,000. Note that 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).

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10 Sociedades de capital de risco.
11 Sociedades anónimas.
Private equity funds

Private equity funds\textsuperscript{12} are contractual funds managed by entities that surpass the thresholds set in the AIFMD: autonomous sets of assets without legal personality that may be managed by private equity companies, regional development entities and entities legally qualified to manage closed-end securities investment funds. Private equity funds are not responsible whatsoever for the debts of the investors, or 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. The minimum subscription amount required per investor is €50,000, with the exception of the directors of the management entity who are not subject to this minimum threshold.

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\textsuperscript{13} 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. 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.

Private equity investment companies

Private equity investment companies\textsuperscript{14} 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 securities investment fund 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\textsuperscript{15} are contractual funds managed by entities above the threshold set in the AIFMD, namely private equity fund management companies or securities investment fund 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.

\textsuperscript{12} Fundos de capital de risco.
\textsuperscript{13} Sociedades gestoras de fundos de capital de risco.
\textsuperscript{14} Sociedades de investimento em capital de risco.
\textsuperscript{15} Organismos de investimento em capital de risco.
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 stringent 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 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.

f **Exclusivity:** provisions regulating the setting up of other funds by the managing entities.

g **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.

h **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.

i **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 may occur, or replacement of the management entities.

j **Most-favoured-nation clause:** provisions set out in the fund’s rules to ensure the principle of equal treatment of the investors. Those provision 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.16

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.

They shall also submit the following documents to the CMVM annually: annual report, balance sheet, financial statements, cash-flow statement, report issued by an auditor registered with the CMVM, and other accounting documents required by law or regulatory regime.17

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.

Note that 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 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 received by the above-mentioned directors.18 It is worth noting that the requirement to set remuneration policies and practices applicable to these 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.

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16 CMVM Regulation No. 3/2015.
17 Ibid.
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.

It is also worth mentioning that 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. These general rules are applicable to private equity participants.

It should be noted that the Law particularises the following duties for management entities:

- to refrain from entering into arrangements that may lead to a clash of interests with investors;
- to set an organisational structure and internal procedures proportional to the size and complexity of their activity;
- to perform their activities to safeguard the legitimate interests of the investors; and
- 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 presentation of documents and the provision of all necessary information for compliance with the legal framework of access to and pursuit 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, but 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.

**Registration and authorisation requirements**

As previously mentioned, the Law creates two different legal regimes, one applicable to managing entities that fall outside the scope of the AIFMD and the 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 swifter than the one applicable to entities outside 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 incorporation of such management entities is subject to a requirement for 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. 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.

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, and (2) the general progressive personal income tax rates of up to 48 per cent, applicable to individual investors acting within the scope of a commercial, industrial or agricultural activity.

Capital gains obtained by Portuguese-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 for corporate entities; (2) the general progressive personal income tax rates up to a maximum rate of 48 per cent for individual investors acting within

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19 The maximum rate of 48 per cent is applicable to income up to €80,640, plus an additional solidarity rate of 2.5 per cent imposed on income exceeding €80,640 and up to €250,000, and of 5 per cent on income exceeding €250,000.

20 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.

21 Plus municipal and state surcharges, if applicable.

22 See footnote 13 above.

23 See footnote 15 above.

24 See footnote 13 above.
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 the 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, 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, it should be noted that 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 slowdown of the recent fundraising activity from international LPs given the current grim economic outlook and the more balanced supply and demand of private equity that exists currently in Portugal. However, several announcements from governmental bodies point towards the continuation of a policy directed at fostering the private equity market in general, so it is likely that public funds will continue to be deployed in the near future.

From a legal perspective, Portugal is witnessing the market adopting some of the innovations created by the Law, such as the capacity to set up a fund with different sub-funds where each sub-fund corresponds to a distinct portfolio of the fund’s assets and liabilities.

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I GENERAL OVERVIEW

Saudi Arabia is widely considered to be a country flush with cash because of its abundant oil reserves and large state coffers. While there is some truth to this belief, the country is currently in a state of transition as oil prices approached their lowest prices in decades during 2016 and 2017. Reduced oil output in compliance with OPEC’s oil production cut agreement, low oil prices and reduced government support led the Saudi economy to contract in 2017 for the first time since the height of the global financial crisis in 2009. For Saudi Arabia 2018 was a year of mixed fortunes, with oil prices firming up before dipping in November as fears of global oversupply, amid a reduction in global economic growth, began to kick in. Although it is estimated that the economy grew by 2.3 per cent in 2018, that is a slower growth rate than previously seen during the oil boom early this decade and the government continues to work towards remedying the weak growth, closing its budget deficit and reducing the country’s high unemployment rate. The 2019 budget for Saudi Arabia, which was announced in December 2018, sets out increased government spending of about 7 per cent to US$295 billion in 2019 in an effort to spur economic growth.

The current economic landscape has been a double-edged sword for the Saudi Arabian private equity fundraising environment as investors are moving away from local listed equities, which, along with local real estate, have been the asset classes of choice for Saudi investors, towards alternative asset classes. However, at the same time, many Saudi investors have much less liquidity, having lost substantial amounts in local investments over the past three years, and are reticent to invest in funds structures.

As such, many sponsors and managers have found fundraising to be difficult. This difficulty is also exacerbated by the fact that very few regional asset managers and private equity funds with considerable track records exist, which is a key factor in successful fundraising.

Fundraising levels have declined for a number of reasons in addition to the current macroeconomic situation, including the decline in the popularity of the typical blind pool fund structure and the increase in popularity of the ‘deal-by-deal’ approach to fundraising. There also seems to be a trend in the Middle East region, and Saudi Arabia in particular, for large family offices and institutional investors to increasingly prefer direct co-investments and, to some extent, managed accounts.

The landscape for local domiciled investment funds is arguably more developed in Saudi Arabia than elsewhere in the MENA region and has proven to be resistant, to a certain

1 James Stull is a partner, Macky O’Sullivan is a senior associate and Sayf Shuqair is an associate at King & Spalding LLP.
extent, to the overall economic and geopolitical developments in the region. This may be in part driven by the Saudi Arabian Capital Market Authority’s (CMA) opening of the capital markets and funds industry to foreign investors and the introduction of new, clearer and more investor-friendly regulations. As mentioned, local listed equities funds have long been the dominant product in Saudi Arabia; however, there has been a clear shift in investor sentiment toward alternatives. Private equity funds focused on certain key sectors, such as healthcare, education and consumer goods, as well as real estate private equity fund, particularly income-generating funds have performed well and have successfully closed in the past year.

The local turbulence within Saudi Arabia has led many investors to look outside Saudi Arabia (and the wider MENA region) towards the more established markets of Europe and the United States, which, despite the geopolitical events in those jurisdictions, are widely seen as significantly more stable than Saudi Arabia. This sentiment has not gone unnoticed by foreign asset managers who are increasingly approaching high-net-worth individuals, families, sovereigns and institutions and marketing their foreign funds as being better alternative investments vehicles to those available in Saudi Arabia (which has experienced a turbulent past year). Noticing this trend, Saudi-based asset managers are increasingly setting up investment funds whose investment strategy is focused on investing mainly in the United States and Europe, with a particular focus on the real estate sector.

The high number of foreign managers coupled with the relative inexperience and limited track record of local managers has resulted in the local managers struggling to raise private equity funds. Only the ‘elite’ local managers are regularly able to complete fundraising successfully. Second-tier managers are often able to syndicate specific deals (with a fully paid-in capital contribution structure) to a small group of target investors but are not capable of raising blind-pool funds.

Regardless of whether a manager is establishing a large blind-pool private equity fund or syndicating a single transaction, the CMA treats all private non-real estate funds in the same manner in terms of registration process. Funds can only be established by ‘authorised persons’ licensed by the CMA to manage assets. The managers must submit the fund’s offering documents for a 15-business-day no-objection period. Assuming the CMA does not object to the offering, a locally domiciled fund may be offered for a one-year period during which the fund manager would typically secure the necessary capital commitments and launch the fund. Fund managers launching single asset funds have generally been successful securing the necessary capital. Fundraising for blind pool venture capital and private equity funds has taken substantially longer and has often required multiple closings or scaling down of the offering size.

Fundraising in Saudi Arabia, as is the case elsewhere in the region, is challenging for many market participants because of the relatively small number of fund managers with an adequately robust track record – particularly successful exits. As such, investors prefer to subscribe to transactions on a deal-by-deal basis rather than via the blind-pool structure seen in more developed markets. The main benefits of the deal-by-deal approach are the transparency and predictability relating to the financial viability and corporate governance of the underlying investment target, and therefore investors have been more comfortable with committing significant capital to a transaction. However, strengthening deal flow powered by a growing number of maturing family businesses in Saudi Arabia may see the demand for general private equity funds grow in number in the near future and Saudi CMA funds competing with other regional funds in terms of fundraising. Further, over the past several
Saudi Arabia

years, venture capital activity has dramatically increased in Saudi Arabia, and because of the small deal size, deal-by-deal syndication of investments is impractical and investors have participated in such blind-pool funds (although the average ticket size tends to be small).

II LEGAL FRAMEWORK FOR FUNDRAISING

With approximately 700 funds domiciled and currently operating in the Kingdom, Saudi Arabia is the most popular jurisdiction in the region for locally domiciled investment funds. This success may be attributed to a number of reasons, including among others the competence of the CMA as the regulator of investment funds in Saudi Arabia and the legal framework the CMA has implemented.

The regulations governing the formation of investment funds have been evolving since the first rules governing mutual fund activity were introduced in 1993. The latest amendments to the Investment Funds Regulations, which became effective in November 2016, streamlined the process for establishing a fund and removed a number of restrictions on private offerings. These amendments are generally viewed as investor-friendly.

A CMA fund is a contractual entity formed between the fund manager and its investors upon execution of the terms and conditions (the form and contents of which are specified by the Investment Fund Regulations). The terms and conditions are the equivalent of a limited partnership agreement for a fund established as a limited partnership or the articles for a fund established as a company. A Saudi Arabian fund may only be established by an entity licensed by the CMA as an authorised person licensed to carry out management activities. The CMA issued new regulations in October 2017 relaxing the process and requirements for applicants to obtain a management licence and dramatically reducing the required share capital (in some cases to as little as 5 million riyals).

Under CMA regulations (and from the perspective of other Saudi governmental authorities and ministries), a Saudi Arabian fund is not considered to be a separate legal entity from the fund manager. Accordingly, the Saudi Arabian Ministry of Commerce and Investment (MoCI) will not issue a commercial registration to a fund (which is a requirement to own shares in companies and other assets in Saudi Arabia such as real estate). Therefore, all actions of a CMA fund must be performed by the fund manager and all assets must be owned by a custodian (or special purpose vehicle established by the foregoing).

In contrast with the MoCI, the CMA considers a Saudi Arabian fund to have a separate legal personality and existence from its manager. However, it is unclear whether all Saudi courts and other governmental authorities take the same position. In the past, certain governmental authorities and regulatory have not seen a fund as an entity distinct from the fund manager.

Because funds are contractual entities regulated by the CMA only, funds are not subject to MoCI’s restrictive companies regulations. Funds are the most flexible vehicles in Saudi Arabia and may provide investors with certain rights and obligations that are not otherwise available under the more typical investment vehicle structure of a limited liability or joint-stock company. These provisions include capital commitment structures, default remedies, dilution, forced exits and redemptions.

The offering documents of a CMA private equity fund follow a prescribed form that is set out in the Investment Funds Regulations. The CMA included a prescribed set of provisions that must be disclosed, which include the investment objective, description of underlying asset, investment strategy, risk factors, fee structure, subscription and redemption
processes (if applicable), valuation mechanism and investor reporting requirements. With the recent amendments that have been introduced, it is clear that the CMA’s position as a regulator is shifting from a more manager-friendly position to an investor protectionist position. In addition, the investors themselves, particularly institutions, sovereigns and large family offices, are becoming increasingly sophisticated and are negotiating certain provisions that historically were not negotiated as much, including those related to fees and governance (including conflicts and advisory committees).

In terms of fundraising and solicitation of investors in Saudi Arabia, it is common for local private equity funds to solicit investors through a typical roadshow process after the lapse of the CMA’s 15-business-day review period. Such funds must be offered by a CMA-licensed manager. For foreign funds, interests may be offered following the lapse of a 10-business-day review period by a promoter licensed by the CMA with an arranging licence. The foreign offeror may not offer the securities directly in Saudi Arabia except through a CMA-licensed promoter, and unlike in certain neighbouring jurisdictions, reverse solicitation is not formally recognised by the CMA as an exemption to registration.

Certain requirements, such as satisfying a minimum investment amount requirement of 1 million Saudi riyals by the investor or confirmation that an investor is ‘sophisticated’ must be satisfied for either local or foreign funds to be offered and the sale to be consummated. Further, in the case of foreign funds, the fund manager must be authorised in a jurisdiction that employs regulatory standards and requirements at least equivalent to those of the CMA and the CMA shall have the discretion to assess whether the jurisdiction has equivalent regulatory standards and requirements. It is unclear whether managers established in many offshore jurisdictions would meet these criteria, although the CMA regularly allows for funds domiciled in major offshore jurisdictions (e.g., the Cayman Islands) to be offered in Saudi Arabia. The distributor must provide an undertaking to the CMA that the offering documents are true, accurate and not misleading – which means that the distributor will generally want to perform a certain level of diligence on the fund and manager as the distributor does not want to make false statements to the CMA. The distributor must submit a report to the CMA of all Saudi investors that subscribed for units in the fund.

Under the Investment Funds Regulations, the manager of a Saudi Arabian private equity fund has a fiduciary duty towards the fund’s investors, which includes the duty to act in the best interests of the investors and a duty to exercise all reasonable care and skill. Further, under the Authorised Persons Regulations (which govern licensing of fund managers in Saudi Arabia), the manager of a Saudi Arabian fund also has the following fiduciary duties: (1) loyalty: a manager must act in all cases in good faith and in the interests of the investors, (2) conflict of interest: a manager must ensure that it safeguards at all times the interests of the investors and that no conflict of interest between its interest and the interests of the investors affects the services that the manager is carrying out, (3) no secret profits: a manager must not use the customer’s property, information or opportunities for its own or anyone else’s benefit unless full disclosure of the usage to the investor is made and consent is obtained, and (4) care, skill and diligence: a manager owes the investors a duty to exercise the care, skill and diligence that would be exercised in the same circumstance by a person having both the knowledge and experience that may reasonably be expected of a person in the same position as the manager; and the actual knowledge and experience that the manager has.
III REGULATORY DEVELOPMENTS

The CMA and the Saudi Arabian Monetary Authority (SAMA) are the governmental bodies that regulate asset management and financing transactions in Saudi Arabia, while the Saudi Arabian General Investment Authority (SAGIA) governs foreign investment. To date, the SAGIA rules have not governed foreign ownership in a CMA fund, and there is no requirement that non-GCC investors in a CMA fund obtain SAGIA approval. A foreign investor’s ownership of units in a CMA fund is only governed by the rules and regulations of the CMA.

During 2016 and 2017, the CMA has issued a number of new regulations intending to encourage foreign investment in Saudi Arabia and stimulate banks and managers to grow assets under management by tapping retail markets and international investors. The CMA also wants to encourage managers to develop products that can be accessed by the Saudi public to encourage individuals to invest their income in the Saudi domestic market. As such, in recent years the CMA has released numerous regulations covering the establishment of new corporate vehicles, the creation of a small-cap market, amendments to the IPO and book-building processes and the easing of the foreign investment requirements into listed equities and funds in Saudi Arabia. In addition, the CMA has promised a complete revamp of existing financial services regulations. Three regulations in particular are pivotal for asset managers looking to raise Saudi Arabia-targeted funds: the amended authorised persons regulations, the rules on the offer of securities and continuing obligations, and the amended investment funds regulations. These regulations have reduced the hurdles to establishing a presence in Saudi Arabia and provide opportunities to investment banks, private equity firms and asset managers to expand their product offerings and access additional capital bases in the country.

The amendments to the authorised persons regulations reduced requirements for applicants to obtain a management licence and dramatically reducing the required share capital (in some cases to as little as 5 million riyals). These amendments also allowed managers to outsource certain functions (such as compliance and finance) for the first time and streamlined the licensing process. The new rules on the offer of securities and continuing obligations similarly streamlined the process for registering, marketing and selling securities in Saudi Arabia and introduced certain favourable exemptions to registration.

The CMA introduced the amended Investment Funds Regulations in 2016 with the hope that they will provide clarity and encourage more managers to launch funds. The CMA had intended for years to revamp the Investment Funds Regulations to address problems of investor protection, which arose during the financial downturn, and cover the launches of a diverse range of new funds, many of which were not contemplated by the 2006 regulations (and in fact introduced similar draft regulations in May 2013 that were ultimately not adopted). The new funds regulations govern the formation, offering and operations of all private and public investment funds in Saudi Arabia, except publicly offered real estate funds. The issuance of the new funds regulations was long expected as the CMA had publicly acknowledged for years that new regulations were in progress.

The CMA intends the new funds regulations to provide clarity and encourage more managers to launch funds. The CMA has intended to revamp the prior regulations to codify unwritten practices of the CMA; address problems of investor protection that arose during the financial downturn; and cover the launch of a diverse range of new funds, many of which
were not contemplated by the earlier version of the regulations. The process for launching a private equity fund or venture capital fund remains essentially unchanged, although the required documentation has been detailed.

There are a number of other provisions of interest. First, a fund manager may not restrict investors of certain nationalities unless the approval of the CMA is obtained. The CMA has indicated that the only restrictions it will apply will be to restrict those private real estate funds that invest in the cities of Mecca and Medina to Saudi Arabian nationals only. Otherwise, all investment funds would be open to foreign investment, regardless of the underlying investments. This is a significant change as it was often considered a grey area whether foreign investors could invest directly into CMA-regulated funds or whether such investors would be prohibited or would have to register through a lengthy process with the Saudi Arabian General Investment Authority. Second, there is no strict requirement to have a fund board for a private investment fund, which in the prior regulations was a statutorily mandated oversight body. This provides managers with more flexibility when it comes to structuring fund governance, but potentially removes protection for investors. Third, under the prior regulations, the maximum number of investors that could be approached in a private placement was 200, but the new regulations do not contain a limit on the number of investors that a manager may approach in a private offering. Lastly, previously an offer would only qualify as a private placement if two requirements were satisfied: (1) that the offerees are sophisticated investors; and (2) that the minimum amount payable per offeree is not less than 1 million Saudi riyals. Under the new fund regulations, only one of the two requirements must be satisfied for an offering to qualify as a private placement. It was widely hoped that the new funds regulations would set out certain exemptions to the requirement to register funds with the CMA; however, none were provided for locally domiciled funds.

The CMA has been encouraging many of the country’s blue-chip and large family-operated companies and financial services companies to list, and created a small-cap market (the Parallel Market or Nomu) in February 2017, which saw over half a dozen listings in its first few months. This move was widely anticipated and well received, and improves access to capital for SMEs and encourages better corporate governance. Further, Saudi Arabia introduced a real estate investment trust (REIT) regime and in November 2016, Riyadh REIT was the first REIT to be listed in Saudi Arabia (and only the second REIT to be listed in the Middle East) and was followed by approximately a dozen other REITs by January 2018. There are currently 18 REITs as at the time of writing. Additionally, the CMA issued regulations in 2018 introducing closed-ended funds that can be traded on the Saudi Stock Exchange. As at the time of writing, no closed-ended traded funds have been established, although managers have been in discussions with the CMA and the first such fund is expected to be listed during the first half of 2019. In general, listings and capital raises in Saudi Arabia have continued to draw interest over the past year (albeit at a slower pace than during 2016 and 2017), while capital markets in other regional and oil-driven economies have dried up.

On 9 January 2018, the CMA issued the amended Rules governing Saudi Arabia’s Qualified Foreign Investor (QFI) framework (the Rules), with effect from 23 January 2018. The amended Rules aimed at easing the qualification requirements for qualified foreign investors, their affiliates, foreign portfolio managers and their managed funds, and expanding the range of institutional investors eligible under this framework. Key changes to the existing Rules include:

a    eliminating the requirement for the CMA’s review and approval of the QFIs’ qualification;
b lowering the assets under management or custody (AUM) requirement for QFIs from US$1 billion to US$500 million;
c qualifying the affiliates of QFIs or foreign portfolio managers and their managed funds without the need to submit separate applications; and
d easing some of the continuous obligations requirements on QFIs.

Tax in Saudi Arabia is administered by the General Authority of Zakat and Tax (GAZT). Under the Saudi Arabian tax regulations, private equity funds are treated as ‘capital companies’, which means (1) they are subject to a 2.5 per cent tax on wealth to the extent the fund is owned by Saudi Arabian nationals or nationals of other countries of the Gulf Cooperation Council (GCC), (2) they are subject to a tax on profits of 20 per cent to the extent the fund is owned by non-GCC investors, and (3) the fund is required to pay a withholding tax of 5 per cent on payments of all dividends and capital gains to investors. However, since 2006, the GAZT has not assessed any taxes on private equity funds in Saudi Arabia or the investors in those funds. This is not a formal exemption and the GAZT has reserved the right to begin taxing funds at any point in the future (including on a retroactive basis). Following a public consultation in July 2017 and August 2017, Saudi Arabia released final value added tax (VAT) regulations through the GAZT website on 29 August 2017. VAT was introduced at a standard rate of 5 per cent on 1 January 2018.

As of today, non-resident investors in Saudi Arabian funds are not subject to tax and payments by funds in Saudi Arabia to non-resident investors are not subject to withholding taxes. That being said, investors and managers in Saudi Arabia should be aware that while funds are currently tax-free, the GAZT has reserved the right to tax funds as if they were companies at any time and on a retroactive basis.

IV OUTLOOK

The CMA is currently reviewing all financial services regulations and trends in Saudi Arabia and is in the process of a massive overhaul of the funds and asset management regulations. This is part of an effort to grow, modernise and diversify the Saudi Arabian economy and to spur foreign investment and new products in Saudi Arabia. While the CMA is a stringent regulator, the funds industry in Saudi Arabia has been a success story compared with the rest of the GCC, and locally domiciled funds have flourished. The CMA and other regulators have encouraged this growth and stability, and have been revolutionising the structuring of private equity in Saudi Arabia. As such, it is expected that Saudi Arabian markets will continue to expand in the coming year despite some of the regional economic turbulence and slump in the price of oil.
I GENERAL OVERVIEW

According to the information contained in the 2018 Report issued by the Spanish Capital, Growth and Investment Association (ASCRI), during 2017, private equity and venture capital entities in Spain raised funds totalling €1.865 billion, which was 17.9 per cent below the 2016 figure. Despite this fall, new fundraisings maintained the levels recorded in recent years, leaving the period stricken by the financial crisis, 2009–2013, far behind.

Of this overall figure, total funds raised in 2017 by private equity funds stood at €1.581 billion, while the funds of venture capital entities amounted to €284 million.

With respect to the origin of the funds raised, funds of funds were again positioned as the main contributors of resources (24.8 per cent), followed very closely by pension funds (20 per cent), whereas national pension funds contributed only €54 million of the €372 million contributed by this type of investor. Family offices and private individuals contributed 13.9 per cent of total funds raised. The public sector also played a significant role in fundraising during 2017, through the funds of funds Fond-ICO Global and Invierte (managed by Axis and CDTI, respectively), which contributed 20 per cent of the total funds raised. The European Investment Fund also remains very active on the Spanish market. In contrast, contributions by Spanish insurance companies were limited to 6.1 per cent, remaining at a level far below that of their European counterparts. Notably, most of the funds were raised from international investors (mainly going to middle-market funds), who contributed 60 per cent of the total funds raised in 2017, and signalling their interest in the Spanish market and their faith in the country’s economy.

To date, the estimates published indicate that the fundraising market in Spain in 2018 has maintained the healthy level of recent years. The ideal conditions for raising new funds (confidence and interest in the Spanish market, liquidity, low interest rates and the continuity of public funds-of-funds programmes) persisted during 2018, resulting in an estimated amount of approximately €2.151 billion of funds raised by private equity and venture capital funds during the past year, which is similar to the 2016 figures.

As to management teams and fundraising periods, the Spanish market has not proved different from other jurisdictions, namely managers with a good track record have been able to raise a greater volume of funds in a period of between six and 12 months, while first-time
teams have required longer periods and a greater involvement of public funds. In this context, it should be noted that reputed national management teams are already incorporating the third and fourth generation of funds.

In the private equity segment, we would highlight as recent significant fundraisings Magnum II (€425 million), Artá Capital Fund II (€400 million), Corpfin Capital Fund V (€300 million), Aurica III (€162 million), GPF II (€150 million) and the debt fund Oquendo III (€200 million); as for venture capital, we would flag up Nauta Tech Invest IV (€155 million) and the first closing of Alta Life Sciences Spain I, managed by Altamar. We have also seen an increase in interest from local and foreign investors in Spanish infrastructure and renewable-energy-focused private equity funds, such as Everwood Fotovoltaica and Helia Renovables.

II LEGAL FRAMEWORK FOR FUNDRAISING

In Spain private equity funds and other alternative investment entities (AIFs) are mostly governed by Law 22/2014 of 12 November (Law 22/2014), regulating private equity and other closed-ended collective investment entities and alternative investment fund management companies (AIFMs), and which implemented Directive 2011/61/EU (AIFMD) into Spanish law and amended Law 35/2003 of 4 November on collective investment entities.

Following implementation of the AIFMD through Law 22/2014, from a regulatory perspective, the product landscape of alternative investments in Spain can be divided into two separate ‘buckets’: (1) open-ended alternative investment vehicles (i.e., hedge funds, real estate investment funds and other open-ended non-UCITS funds), which are regulated in Spain by Law 35/2003 (as amended to implement Directive 2009/65/EC); and (2) private equity or venture capital and closed-ended collective investments vehicles, regulated by Law 22/2014, which applies to closed-ended AIFs domiciled and distributed in Spain and Spain-based alternative investment fund managers.

Without minimising the importance in the Spanish alternative investment scene of the open-ended collective investment vehicles mentioned above, it can be confidently said that, after the implementation of the AIFMD, private equity activity in Spain has mostly been pursued under private equity and venture capital structures, in the form of private equity or venture capital funds, or limited liability companies.

Both Spain-based alternative investment fund managers and national and foreign investors have been receptive to the closed-ended structures available in Spain (described below) when the fund is aimed at equity investments. As proven by the number of funds raised during 2017, described in Section I, Spain has consolidated itself as a friendly jurisdiction for establishing closed-ended AIFs whose investment strategy is focused on equity assets located in Spain or certain European regions. However, the forms of closed-ended collective investment vehicles available in Spain have been generally disregarded by managers of mezzanine and other debt-based AIFs, who have preferred to set up their operations in other EU jurisdictions, such as Luxembourg.

i Legal forms for closed-ended alternative investment vehicles

Law 22/2014 defines closed-ended alternative investment as the activity pursued by both private equity and venture capital entities (ECRs) and closed-ended collective investment entities (EICCs).
EICCs are defined as any collective investment entity – other than ECRs and open-ended alternative investment vehicles regulated under Law 35/2003 – lacking a commercial or industrial purpose, which solicits capital from a series of investors for it to invest in any form of financial or non-financial assets, pursuant to a clearly defined investment policy. This very broad definition is intended to have a force of attraction, so that any form of capital solicitation (i.e., marketing or distribution) for collective investment vehicles in the private market in Spain will be subject to registration requirements and regulatory oversight by the Spanish National Securities Market Commission (CNMV).

ECRs are defined as EICCs whose investment policy is limited to temporary investments in private companies other than real estate companies or financial entities or assets. As a sub-type of ECRs, Law 22/2014 provides for a specific regime applicable to ECRs whose investment policy is aimed at investing in small and medium-sized enterprises (SMEs), the ECR-SMEs.

Both ECRs (including ECR-SMEs) and EICCs can be created in the form of a fund (FCR/FICC) or a limited liability company (SCR/SICC). Among others, the essential practical differences between ECRs and EICCs – in favour of the ECR – are (1) the preferential tax treatment that Spanish laws afford ECRs and (2) the ability to market ECRs to retail investors who comply with certain minimum requirements (see Section II.vi). On the other hand, EICCs are not subject to the investment limitations, thresholds and diversification obligations to which ECRs (including ECR-SMEs) are subject.

We summarise below the main features of the most common forms of closed-ended AIFs in Spain.

ii Private equity and venture capital funds

The most common form of AIF in Spain where the sponsor is a Spain-based registered AIFM is a private equity or venture capital fund (FCR). An FCR is a separate pool of capital held by a number of investors with no legal personality whose management and representation is legally bestowed upon a duly registered AIFM and whose constitutional documents and investment policy comply with the ECR requirements under Law 22/2014.

An FCR is the institution under Spanish law that most closely replicates the Anglo-Saxon limited partnership-type of fund structure. Making a simplified comparative analysis, the AIFM and the holders of FCR participations would be, respectively, the equivalent of the general partner and the LPs under a limited partnership-type of fund structure.

The FCR is legally created upon the cumulative completion of the following steps: (1) the initial contribution of a minimum amount of funds or eligible assets by one or more investors and, as the case may be, the AIFM; (2) the formalisation of the relevant contract for the creation of the fund, which must include, among other things, the FCR’s management regulations and defined investment policy; and (3) the filing and registration with the CNMV of (1) of the fund contract, (2) the prospectus, including all the information about the AIF and the AIFM required under Law 22/2014, and (3) if the FCR is marketed to retail clients, the key information document required under Regulation (EU) No. 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (the PRIIPS Regulation).

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2 According to the information available at the CNMV website (www.cnmv.es) a total of 197 FCRs were registered with the CNMV as at 23 January 2019, which included eight FCR-SMEs and eight FCREs.
The creation of an FCR is not subject to prior authorisation by the CNMV, but it has to be registered with the CNMV registry before the AIFM can start the FCR’s marketing and operations. The role of the CNMV registry is limited to checking the completeness of the documentation filed for registration, without prejudice to the oversight capacity and disciplinary powers of the CNMV over the sponsor AIFM in relation to its pursuit of marketing or distribution and management activities related to the FCR. The CNMV usually takes two to 10 days to register the FCR.

A qualified AIFM may choose to set up a European FCR (FCRE), in which case, the FCR must comply with the requirements under EU Regulation No. 345/2013, as amended by EU Regulation 1991/2017.

The mandatory content of the management regulations is very similar to the content required of other equivalent alternative investment vehicles in other EU jurisdictions, including the specific defined investment policy. In Spanish market practice, FCR management regulations commonly include the most typical key legal terms covered by Anglo-Saxon limited partnership agreements.

The following are some of the most typical negotiable terms of FCR management regulations and some of their current trends:

a. term (10 years + one + one) and investment period (five years + one);
b. management fees: more and more often we find management fees that vary among investors according to volume invested, time of the investment, etc., and even no payment of a management fee on team commitments. There is also a tendency to impose a global limit on the management fees received by the managers throughout the life of the fund;
c. increasingly detailed regulation of co-investment opportunities, exclusivity of the management company and conflict of interests that affect the management team, the management company and the fund;
d. removal of the management company (1) with cause, adding, as usual causes, unsolved key man events and change of control and (2) without cause, with an increasingly detailed vesting scheme of the carried interest;
e. parallel fund structures and their regulation;
ff. increasingly detailed regulation of recycling options and temporary distributions; and
g. limitations on indemnities of the management team in connection with third-party claims.

iii Private equity or venture capital limited liability company

The most-used form of AIF in Spain after the FCR is the private equity or venture capital company (SCR). An SCR is a limited liability company whose constitutional documents and investment policy comply with the ECR requirements under Law 22/2014.

Compared with the FCR, the main practical differences displayed by the SCR are described in the following paragraphs.

An SCR may be managed internally (i.e., by providing it with all the requisite management resources, both human and material) or externally (i.e., by a duly registered AIFM).

As an exception to the general rule, the incorporation of an internally managed SCR is subject to prior authorisation by the CNMV, a process that is substantially equivalent to

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3 According to the information available at the CNMV website (www.cnmv.es) a total of 138 SCRs were registered with the CNMV as at 23 January 2019, which included 17 SCR-SMEs.
that of the authorisation of an AIFM. The possibility of internal management allows for an investor or a number of investors to sponsor the creation of an SCR, without the presence of an AIFM.

It is also possible to create an internally managed SCR that delegates certain AIF management functions to a duly registered AIFM or other authorised collective investment management or financial entities.

In terms of incorporation and the setting up of its activity, an SCR externally managed by a duly registered AIFM is not subject to prior authorisation by the CNMV, but only to a post-incorporation registration requirement similar to the regime applicable to an FCR.

As a consequence of their corporate form, SCRs are subject to the Spanish Capital Companies Act in any and all matters not expressly regulated under Law 22/2014.

Therefore, the SCR must be incorporated by execution of a public deed in front of a notary and must be registered at the Companies Registry, a process that may take up to 15 days. This is a prerequisite for filing the incorporation documents with the CNMV, which then follows the same procedure as it does with FCRs. This duplication of registration processes entails a substantial delay in the incorporation of the vehicle, which is avoided in FCR structures.

Certain decisions will be reserved to the board of directors or the general shareholders’ meeting according to the law. The legal rules and mandatory prior notice periods applicable to the calling of the shareholders’ meeting or the board meeting will apply, while the FCR management regulations provide more flexibility when it comes to the internal organisation of the decision-making process.

In the case of an externally managed SCR, such decision-making may not be delegated to the AIFM, which, from a practical perspective, results in additional formal requirements and shareholder involvement in the investment or divestment decision process.

The rules on dividend distributions, share capital increases and reductions, the creation of reserves and other creditor protection provisions in the Spanish Capital Companies Act will apply, making the SCR a less flexible vehicle than the FCR for those purposes.

In terms of fund documentation, in the case of an SCR, the typical terms included in the limited partnership agreement in Anglo-Saxon structures or in the fund management regulations described in Section II.ii are also included in the SCR contractual documentation. However, instead of most of these terms being included in a single document, such as the FCR management regulations, they are split between: (1) the SCR by-laws, (2) the management agreement entered into between the AIFM and the SCR, (3) the private placement memorandum or prospectus, (4) the investment commitment letters, and (5) in internally managed SCRs or SCRs with a reduced number of significant investors, shareholders’ agreements or side agreements.

iii EICC

Despite the additional investment management flexibility offered by EICCs, the lack of a privileged tax regime and the inability of AIFMs to market EICCs to retail investors have substantially limited the potential for expansion of the use of EICCs. As at 23 January 2019, according to information publicly available on the CNMV website, only 20 SICCs and 14 FICCs are registered with the relevant registries of the CNMV.

That said, it must be noted that this type of entity, both in the corporate and fund forms, represents an opportunity for Spanish AIFMs to expand their fundraising activities, as they allow AIFMs to search for new alternative investment opportunities in financial, real
estate, commodities and other assets that are not eligible for ECR vehicles or that, although eligible, the maturity or other characteristics of the investment would be incompatible with the investment limitations and diversification obligations required of ECRs.

v Legal regime applicable to alternative investment fund managers in relation to fundraising

AIFMs regulated by Law 22/2014 must apply for authorisation by the CNMV to conduct their activities. For an AIFM to be authorised by the CNMV to pursue AIF management activities, it has to comply with all the AIFMD requirements as these have been implemented into Spanish law by Law 22/2014. Among others, an AIFM must be sourced with sufficient capital, human talent and material resources and be organised in a manner that ensures the provision to the AIF of the common functions of professionally regulated investment managers, such as investment portfolio management, risk management, liquidity management, compliance, internal audit, valuation, etc. The remuneration policy, incentive schemes, delegation of functions to third parties, conflicts of interest management and any other policies related to the AIFM functions must comply with the principles set out in Law 22/2014 and EU regulations and standards.

As regards the depositary function, Law 22/2014 establishes that the AIFM may perform this function if the AIFs that it manages are not marketed to retail investors and the assets under management by the AIFM do not exceed (1) €100 million, if the AIFs managed use leverage, or (2) €500 million, if none of the AIFs managed by the AIFM use leverage or have shareholders’ redemption rights in a period shorter than five years. If the AIFM markets the AIF to retail investors or the above thresholds are exceeded, the AIFM must appoint a third-party qualified depositary for each AIF that it manages.

Once the AIFM is authorised by the CNMV and fully operative, it must comply with a number of fiduciary duties in relation to the investors and must observe certain basic conduct principles expressly provided for under Law 22/2014. Those fiduciary duties and principles apply across all lines of activity and functions of the AIFM, but two of those duties are particularly relevant in the context of the fundraising process: (1) the fiduciary duty of loyalty (including the obligation to avoid and manage conflicts of interest) and (2) the equal treatment principle.

To minimise and manage conflicts of interest, AIFMs must (1) devise and formalise organisational procedures to avoid, detect, control and manage conflicts of interest that may harm the interest of the investors and (2) implement those procedures and regulations loyally to the interests of investors, including taking any necessary organisational actions that may be required to remove persistent conflicts of interest. Additionally, the AIFM and its managers and shareholders must disclose their holdings, investments or relations with entities that may potentially result in a conflict of interest that may not be controlled and managed by the organisational and administrative mechanisms envisaged in the organisational procedures.

Albeit an essential investor protection rule, the equal treatment principle is probably the principle with the most impact on the fundraising process. As anticipated in Section II.ii above, it is becoming increasingly common to have fee structures that differentiate investors depending on the volume invested, timing of the investment, etc. Law 22/2014 frames the equal treatment principle with a degree of flexibility, subject to strict compliance with the full transparency principle, which serves as the positive limit to this flexibility. Thus, in Spain, AIFMs are allowed to afford a different or privileged treatment to a particular investor or category of investors as long as this different or privileged treatment is expressly and
transparently disclosed in the management regulations, constitutional documents and the AIF’s private placement memorandum or prospectus. In Spanish fundraising practice, it is also becoming relatively common to complete the provisions of the management regulations or constitutional documents relating to the equal-treatment principle by introducing a ‘most-favoured-investor’ clause, to ensure that any future investor encountering the same conditions as those that resulted in the original investor being granted special treatment is afforded the same treatment.

vi Marketing and distribution

Law 22/2014 defines marketing and distribution of ECR and EICC shares very broadly, including any form of direct or indirect solicitation of investment by any type of investor in the ECR and EICC.

As a general rule, shares in an ECR or EICC may only be marketed and distributed to professional investors. However, to allow AIFMs to market ECRs to investors who would otherwise be treated as retail investors according to Spanish capital markets regulations or MiFID, but who are, for example, high-net-worth individuals, family offices or any other type of investor whose classification under MiFID could be disputed, Law 22/2014 expressly provides for an exception that substantially expands the potential investor base to which the sponsor AIFM can direct its marketing efforts.

Law 22/2014 allows AIFMs to market the shares in an ECR (but not in an EICC) to any retail investors to the extent (1) it has provided the relevant investor with the prospectus, the management regulations, annual report or any other relevant information on the investment in the ECR prior to the subscription of the shares or the commitment letter, and (2) the following minimum requirements are fulfilled:

- the investor commits of a minimum amount of €100,000; and
- the investor states in writing, in a document separate from the commitment letter or contract, that it is aware of the risks of investing in the ECR.

Following the entry into force of the PRIIPs Regulation in 2018, the AIFM must also provide retail investors with the applicable key information document. The AIFM must obtain evidence that the retail investor has the required knowledge, expertise and experience to independently evaluate the risks of the investment in ECR shares and has to keep supporting written documentation of the analysis of the fulfilment of the requirements performed by the AIFM and the positive outcome.

However, EICC shares can also be acquired or subscribed by retail investors if (1) no marketing or distribution has taken place (i.e., the subscription results from the unsolicited expression of interest by the retail investor, known as ‘reverse solicitation’), and (2) the requirements under (a) and (b) above have been met.

From a practical perspective, it could be said that the most common forms of marketing and solicitation by AIFMs in Spain are direct solicitation and by delegation of the marketing function to a private placement agent. The limited number of professional institutional investors and the existence of prominent industry associations are key factors in having AIFMs choose the personal approach to institutional investors. This takes the form of direct presentations and roadshows, which is becoming increasingly popular among the most prestigious Spanish AIFMs, whose AIFs are aimed exclusively at professional investors and have a previous track record and direct contact with investors in previous funds managed by such AIFMs. On the other hand, in the case of newcomers, using private placement agents is
probably the most common form of addressing the fundraising. Additionally, when AIFMs – taking advantage of the option provided by Law 22/2014 – intend to market ECRs to retail investors, they usually delegate the marketing and distribution of the product to the private banking arm of financial institutions or specialised wealth management firms.

vii  Key disclosure items during the fundraising period

From a regulatory perspective, Law 22/2014 sets out the obligation of the AIFM to deliver to the investor, before its investment is formalised, a prospectus or private placement memorandum including the AIF management regulations or by-laws and, among other things, a description of:

a the investment policy and strategy, including geographic area, instruments, risk profile, use of leverage and associated risks and limitations on investment;
b the procedures to amend the investment policy and strategy;
c the legal implications of the underlying contractual relations;
d the identity of the auditor, depositary (if applicable), entities to which the AIFM may have delegated certain functions, and any other relevant suppliers of the AIFM;
e risk management tools used by the AIFM;
f the valuation criteria and methodology;
g liquidity risk management tools;
h any fees and costs to be borne by the investors;
i the preferential treatment afforded to an investor or category of investors, if any, the mechanisms to ensure equal treatment to all investors, any relations that may exist between certain investors and the AIFM and any information related to conflicts of interest;
j the historical track record of the relevant ECR or EICC, if available;
k any relation with financial intermediaries, placement agents, etc.; and
l if applicable, information about the use of leverage.

In addition to the mandatory prospectus disclosure described above, it is common practice in Spain (as in other jurisdictions where private equity has become a common financing tool) for the AIFM to prepare a set of due diligence materials with additional detailed information about the AIFM, the key managers and the key due diligence items commonly required by professional institutional investors. These materials are complemented by a question-and-answer (Q&A) process. The usual topics disclosed in the due diligence materials include an executive summary of the main transactions completed in the past by the AIFM team, the organisation of the AIFM, the experience of the team members, their roles, details of the shareholders of the AIFM and certain financial information such as the co-investment commitment of the AIFM team, the carried interest general vesting rules, management fees and operating budget. It is also common for information to be requested on previous fund returns, benchmark fee comparisons, potential deal flow pipeline, portfolio packs, value creation analysis, practical details of the investment process and certain legal documentation.
III REGULATORY DEVELOPMENTS

i Regulatory oversight and recent developments
As indicated in the previous sections, the Spanish governmental agency in charge of overseeing funds, the fundraising process and the relationship between the AIFM and the alternative investment investors is the CNMV.

Setting aside regulatory developments at EU level, there have been a few regulatory developments from a purely Spanish standpoint:

a on 14 December 2018, the government enacted Royal Decree-Law 22/2018, on macro prudential tools, which enables the CNMV to require AIFMs to increase the proportion of their investments in liquid assets should the need arise to guarantee financial stability or to ensure application of the equal treatment principle;

b on 26 November 2018 the CNMV issued Circular 5/2018, establishing further transparency and reporting requirements for AIFMs, especially in connection with variable remuneration received by AIFM employees; and

c in 2018, the Spanish government transposed MiFID II into Spanish law through several amendments to the financial conduct rules under the Spanish Capital Markets Act, applicable, by reference, to AIFMs.

Notwithstanding the various Circulars issued by the CNMV (whose content is mainly technical), Law 22/2014 remains the only Spanish legal instrument implementing the AIFMD into the country’s legal system, with Law 25/2003 applying secondarily to AIFMs in all matters not expressly regulated under Law 22/2014.

On 13 October 2016, the CNMV issued a Q&A document answering certain questions about its interpretation of certain provisions of Law 22/2014; the document was updated on 23 November 2018 and is publicly available through the CNMV website.

ii General remarks on tax treatment of closed-ended AIF
Both ECRs and EICCs are fully liable to corporate income tax in Spain (with no possibility or option of being tax-exempt) and therefore cannot be treated as fiscally transparent or as flow-through entities. Both types of entity are eligible for the Spanish general participation exemption, provided that they comply with the requirements imposed under Article 21 of Law 27/2014 of 27 November 2014 (the CIT Law), including, among other things: (1) holding a minimum ownership percentage of at least 5 per cent or acquisition cost of at least €20 million; and (2) a minimum holding period of at least one year.

ECRs can also benefit from a special tax regime applicable to capital gains and dividends obtained from qualifying investments, but only where those investments do not meet the following criteria for the Spanish general participation exemption:

a Capital gains obtained by an ECR on the transfer of its Spanish and non-Spanish qualifying investments will be 99 per cent exempt, provided that the transfer takes place between the second and the 15th year of investment (both inclusive). Subject to the approval of the Spanish tax authorities, this term may be extended to up to 20 years in certain cases. If the qualifying investment is floated on a regulated stock exchange, divestment should occur no later than three years after the initial public offering for the ECR to benefit from the special regime.
Dividends or distributions of profits obtained from qualifying investments will be eligible for the Spanish general participation exemption without the holding threshold or period requirements having to be met.

There is no provision under the special tax regime that refers to interest income and, accordingly, ECRs and EICCs will be subject to the general corporate income tax regime with regard to any interest income, whether from a Spanish or foreign source.

The special tax regime stipulates a specific tax treatment for ECR investors, applicable to dividends and capital gains received from their holdings in ECRs, which in turn depend on the nature and residence of each investor:

a. Spanish corporate tax taxpayers (as well as non-resident investors acting in Spain through a permanent establishment) will be entitled to apply the Spanish general participation exemption without the holding threshold or period requirements having to be met for dividends obtained and capital gains disclosed on their holdings in ECRs.

b. Non-resident individuals or corporations without a permanent establishment in Spain will not be taxed in Spain on dividends obtained and capital gains disclosed on their holdings in ECRs, unless they obtain them through, or are located in, a tax haven, in which case they will be subject to non-resident income tax.

c. Spanish-resident individuals will be taxed at their general individual tax rates on dividends obtained and capital gains disclosed on their holdings in ECRs.

IV OUTLOOK

In our view, the outlook for the private equity markets in Spain remains positive. The number of newcomers and third- and fourth-generation funds raised by consolidated management teams is increasing, and the volume of alternative investment assets under management by the most prestigious management teams continues to grow. Despite some political uncertainty, both global and local, the perceived general international investor consensus is that Spain is an attractive market offering interesting investment opportunities – 60 per cent of total funds raised in 2017 came from international sources – and this indicates that the Spanish fundraising market will continue to be very active in the coming years.

In terms of trends, we would highlight (1) GP-led secondary transactions (i.e., processes instigated by the manager of an ageing fund to allow investors to walk away with a distribution or remain invested in some way, usually in a new vehicle); (2) LPs’ direct co-investment transactions; and (3) the increase in the number of participants and of the contribution of public funds to venture capital – with a particular focus on digital business and innovation, and sustainability and social impact funds.
I GENERAL OVERVIEW

The year 2017 was a successful one for fundraising, with an aggregate amount of €4.275 billion raised by private equity funds in Switzerland. This figure is significantly higher than the amount raised in 2016 (€704 million), in 2015 (€1.280 billion) and 2014 (€3.301 billion). Most of the fundraising activity 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. 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 the different industries. In 2018, Switzerland was ranked in top position, for the eighth consecutive year, as the world leader for innovation by the Global Innovation Index. According to the Swiss Venture Capital Report of 2018, financing rounds increased by 15.9 per cent in 2017 from 151 in 2016 to 175 in 2017. That said, the total amount of money invested in Swiss start-ups increased by only 3.2 per cent, from 909 million Swiss francs in 2016 to 939 million Swiss francs in 2017. Biotech and information and communications technology continued to grow in 2017 with an increase of more than 10 per cent over the previous year. The financial technology (fintech) industry also rose sharply, by 61.8 per cent, to reach 75.7 million Swiss francs, with a high number of financing rounds above 3 million Swiss francs. For the fintech industry, the decisive considerations remain financing and fundraising.

The venture capital market has gained in size and this trend is likely to continue in view of the Swiss Entrepreneurs Foundation’s aims to raise a fund of up to 500 million Swiss francs to support Swiss start-ups. The fund is expected to be launched in the first half of 2019, upon receipt of authorisation from the Swiss Financial Market Supervisory Authority (FINMA). 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 at Listed Companies, various obligations have increased the cost of investment in public companies therefore many investors choose to invest in start-ups.

II LEGAL FRAMEWORK FOR FUNDRAISING

Fundraising in or from Switzerland through the use of collective investment schemes (CISs) is governed by the Collective Investment Schemes Act of 23 June 2006 (CISA) and its implementing ordinances (CISO and FINMA-CISO). Switzerland is not a Member State of the European Union and is therefore not subject to the EU Alternative Investment Funds Managers Directive (AIFMD). That being said, the 2013 revision of the CISA, among other things, 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.

The regulatory framework applicable to CISs has not materially changed since the 2013 revision of the CISA. That said, a number of significant changes to the CISA are contemplated as part of the Swiss financial regulation overhaul through the Swiss Federal Financial Services Act (FinSA) and the Swiss Federal Financial Institutions Act (FinIA), which will enter into force on 1 January 2020. The Swiss parliament enacted these two statutes on 15 June 2018. On 24 October 2018, the Swiss Federal Council opened a consultation procedure, which will run until 6 February 2019, on the implementing ordinances of the FinSA and FinIA, namely the Financial Services Ordinance (FinSO) and the Financial Institution Ordinance (FinIO). The new statutes are largely inspired by the EU financial markets and services regulations (MiFID, Prospectus Directive, PRIIPs) and will provide, among other changes, for (1) an abolition of licensing requirement for Swiss distributors, (2) the concept of ‘offer’ to replace the existing concept of ‘distribution’, (3) an alignment of the client categorisation rules based on EU MiFID concepts, and (4) a limitation of the requirement to appoint a Swiss representative and paying agent for offers of collective investments to qualified investors. In addition, non-Swiss financial service providers acting on a cross-border basis will be subject to Swiss rules of conduct, as well as, under certain circumstances, registration duties, or they may be required to set up a business presence in Switzerland with respect to their Switzerland-based customers.

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 CIS specifically aimed at alternative investments, private equity investments 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 it 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.iv). 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).

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 the 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.

It should be noted that 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 or their shareholders are exclusively qualified investors as defined under the CISA (see Section II.iv). 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.

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6 As a consequence of the limitation of the circle of investors, a Swiss LP cannot be listed on a securities exchange.

7 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.
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 aspects, jurisdictions of investee entities and other factors. 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 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;
i voting quorums and majorities;
j restrictions on the transferability of the interests; and
k distribution of proceeds.

The SFAMA and the SECA jointly developed a model prospectus and a company agreement for the Swiss LP, which has been recognised by FINMA for the purposes of authorisation applications.8

vi 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

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8 Available at: https://www.seca.ch/Templates/Templates/LP-Musterdokumentation.aspx.
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.iv) 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.

vii Marketing rules and investor classification

Concept of ‘distribution’

Any offer or advertisement for a CIS that is not exclusively directed towards regulated financial intermediaries (e.g., banks, insurance, companies, securities dealers, fund administration companies, fund asset managers and central banks) is construed as distribution, which is subject to specific CISA requirements both for the CIS and the distributor. Indirect distribution is also subject to the same requirements (e.g., offering managed accounts in CISs or fund-linked notes, depending on the specific facts).

The CISA excludes the four situations outlined below from the definition of distribution. As result, the provision of information or the offer of CISs are deemed not to constitute a form of distribution if they take place:

a at the investor’s request within the context of a long-term and remunerated advisory agreement or an execution-only relationship with a regulated financial intermediary or with an independent asset manager (subject to certain conditions);

b at the instigation of investors or on their own initiative in relation to a specific CIS and without any intervention or prior contact made by the financial intermediary (reverse solicitation);

c within the context of a written discretionary management agreement entered into by the investor with a regulated financial intermediary or an independent asset manager (subject to additional conditions); and

d the publication of prices, net asset values and tax data by regulated financial intermediaries.

Notably, the new regulatory framework that enters into force on 1 January 2020 will replace the concept of ‘distribution’ with the concept of ‘offer’. The latter is defined as an invitation to acquire a financial instrument that contains sufficient information on the conditions of the offer and the terms of the financial instrument. Under the current understanding and pending the adoption of the draft FinSO, the definition of offer is expected to be more limited than the current concept of ‘distribution’, but the final approach will be known once the ordinances have been finalised and FINMA’s regulatory practice firmed up.

Further, the distributor licence currently existing under the CISA will be abolished. That said, financial services providers offering CISs will probably have to (1) comply with the
rules of conduct provided under the FinSA and (2) register their client advisers in the newly introduced adviser register (subject to exceptions). The obligation to register in the adviser register is expected to be applicable as of 1 July 2020, after a transition period.

**Concept of ‘qualified investors’**

The concept of ‘qualified investors’ is another important regulatory concept in the context of the distribution of CISs. Under the CISA, the concept of ‘qualified investors’ comprises:

- **regulated qualified investors:**
  - regulated financial intermediaries, including banks, securities dealers, fund administration companies and managers of collective investment schemes, as well as central banks; and
  - regulated insurance companies; and

- **unregulated qualified investors:**
  - public entities, retirement benefit institutions (pension funds) and companies with professional treasury management (this concept presupposes that the entity has at least one qualified professional in charge of the management of its financial assets);
  - companies with professional treasury management;
  - investors who have concluded a written discretionary asset management agreement, provided they do not exercise their right to opt out of the ‘qualified investor’ status and the agreement is entered into with a regulated Swiss financial intermediary (namely, those that are referred to as ‘regulated qualified investors’) or with an independent asset manager (subject to certain conditions); and
  - high-net-worth individuals (HNWIs) and private investment structures created for HNWIs that have requested, in writing, to be considered qualified investors (opt-in declaration), provided they, in addition, confirm that they hold a minimum net wealth of 5 million Swiss francs, or establish that they have, based on their professional training and experience, the technical competence of a qualified investor combined with a minimum net wealth of 500,000 Swiss francs.

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 distribution of interests in CISs (see below).

Upon the entry into force of the revised CISA on 1 January 2020, the distinction between qualified and non-qualified investors will be maintained. The definition of the qualified investor will nevertheless be adjusted to be in line with the new client segmentation system that is contemplated by the FinSA. In a nutshell, all professional investors under the FinSA will be deemed qualified investors. The concept of ‘professional investors’ will include all institutional clients and, *inter alia*, investment vehicles for HNWIs with a professional treasury management, large companies (under certain conditions) and HNWIs opting to be treated as professional investors. In this regard, the current minimum threshold of 5 million Swiss francs for the HNWI opt-in declaration will be lowered to 2 million Swiss francs (regardless of knowledge or experience).
Distribution of units in Swiss LPs

As mentioned above, private equity funds that are incorporated as a Swiss LP may only be distributed 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.

It should be noted that, 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.

Distribution of foreign private equity funds to non-qualified investors

Foreign private equity funds may be distributed to non-qualified investors (i.e., retail investors) in Switzerland if those 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 distribution to non-qualified investors in Switzerland, insofar as many of the requirements (typically, items (a) and (b) above, are not met).

Distribution of foreign private equity funds to qualified investors

Notwithstanding the above, foreign funds may still be distributed to qualified investors. By contrast to distribution to regulated qualified investors (which is excluded from the scope of any requirements on distribution), distribution to unregulated qualified investors (see above) is permissible provided that:

a. the distributor is subject to appropriate supervision in its home jurisdiction in respect of fund distribution;

b. a Swiss representative, as well as a paying agent, is appointed by the CIS;

c. the name of the CIS is not confusing for the investors; and

d. the distributor enters into 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).
In this context, anyone who distributes foreign CISs to unregulated qualified investors in Switzerland (as opposed to an exclusive cross-border activity) is deemed to be a fund distributor and must further be authorised by FINMA as such.

It should be noted that, as of 1 January 2020, the revised CISA will introduce a new regime for the offer of foreign CISs to qualified investors. Foreign CISs offered exclusively to qualified investors, other than to HNWIs who opted in to be treated as professional clients or qualified investors, will be exempt from the requirement to appoint a representative and a paying agent in Switzerland. This is expected to facilitate access to the Swiss distribution channels in most instances.

**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, as mentioned above, the Transparency Guidelines provide for further disclosure duties with respect to fees, costs, retrocessions and rebates that apply in this context. This regulatory framework will evolve, as of 1 January 2020, with the removal of all provisions regarding distribution within the CISA.

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.

Finally, under the CISA, 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.

**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.

It is worth noting that 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, as previously mentioned, a registration with FINMA is required before foreign CISs can be distributed in or from Switzerland to non-qualified investors (see Section II.iv).

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. An exception applies to asset managers of foreign CISs whose investors are unregulated qualified investors if:

- the assets under management, including those resulting from the use of leverage, are below the threshold of 100 million Swiss francs;
- the assets under management are below 500 million Swiss francs (unleveraged) and closed-ended (such as the Swiss LP) for a period of five years; or
- the investors are exclusively group companies of the asset managers group.
Non-Swiss managers of both Swiss and non-Swiss CISs having a branch in Switzerland are also required to register with FINMA. This presupposes that the foreign asset manager:

- is subject to adequate supervision by its home regulator;
- has sufficient financial resources, adequate organisation, as well as competent staff to operate a branch in Switzerland; and
- is incorporated in a jurisdiction where its home regulator has concluded a specific cooperation agreement with FINMA.

As a matter of principle, the sponsor or promoter of a fund is not subject to Swiss regulatory registration, as long as it does not perform any specific regulated activity, such as fund asset management, distribution of CISs or representation of foreign CISs. The mere advisory activity is not subject, for the time being, to any licensing requirement. It should, however, be noted that, according to FINMA Circular 2013/9 on distribution of CISs, discretionary management mandates aiming at investing solely or predominantly in funds (e.g., ‘managed fund accounts’) may be considered an activity of (indirect) distribution of funds by FINMA therefore requiring a distributor licence.

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, on 16 February 2018, 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.

Overall, the Swiss regulatory framework is expected to remain in a state of flux over the coming years, with changes aiming at promoting innovation in the financial sector while increasing client protection. In this context, the Swiss Federal Council published in December 2018 a report on the legal framework for blockchain and distributed ledger technology in the financial sector. The report noted that the Swiss legal framework is well prepared to deal with new technologies, while a few selective adjustments are expected to be implemented in the next few years.

Separately, as of 1 January 2020, the new FinSA and FinIA regime will overhaul the regulatory framework applicable to the provision of financial services in Switzerland, including in the private equity investments sector.

Switzerland also aims to improve competitiveness in the area of collective investments. In September 2018, the Swiss Federal Council announced its intention to introduce a new category of funds that are neither subject to approval by FINMA nor regulated under the CISA. This new category of funds, ‘Limited Qualified Investment Funds’, would be limited to qualified investors such as pension funds and insurers.
I GENERAL OVERVIEW

Despite the financial downturn and the decline in oil prices that has recently characterised the United Arab Emirates (UAE), the country has weathered the storm and maintained its position as the centre for private equity in the Middle East and North Africa (MENA) region. It is projected that the partial recovery in oil prices in 2018, coupled with the ongoing all-out diversification drive and the recent tax reforms, will help the UAE economy to gain increased momentum in 2019. Over the past couple of years, the UAE has emerged and maintained its status as the preferred investment destination for most private equity and venture capital participants in the MENA region. This positive sentiment may in part be explained by the UAE’s relatively diversified economy, and also be connected to increased concerns over economic and political factors in other leading MENA countries in the private equity arena such as Saudi Arabia and Qatar.

During the global financial crisis, Dubai, with a focus on real estate and financial transactions, was particularly hard hit, resulting in a near default on its debt payments and a subsequent bailout from Abu Dhabi. Many predicted the financial crisis would be the end of Dubai and would result in a transformative change to Dubai’s free-spending and ‘casino-like’ culture. However, following certain significant restructurings and policy changes, Dubai has entered a period of sustainable growth, with significant projects in the tourism and real estate sectors announced in anticipation of the World Expo in 2020 – although the real estate sector has experienced sluggish growth over the past year. Abu Dhabi weathered the financial crisis by implementing a patient economic vision, buoyed by high oil prices. This approach resulted in four straight years of double-digit fiscal surpluses in the lead-up to 2015, which in turn led to massive budgets for the government to invest in mega projects, and to focus on important sectors of the economy such as healthcare and education. With an economy predominantly based on oil and related hydrocarbon revenues, the recent slump in oil prices has drastically reduced revenues for Abu Dhabi, which appears to be entering a stage of economic transition toward a more sustainable and diversified economy highlighted in the Abu Dhabi Vision 2030.

Considering the characteristics of the current landscape, governments and regulators in the wider GCC region are taking serious steps towards diversifying their economies and encouraging market competition and focusing on synergies and efficiencies. The most prominent examples have been the consolidation of several high-profile Abu Dhabi sovereign...
entities (e.g., Mubadala Investment Company’s recent acquisitions of International Petroleum Investment Company (IPIC) and Abu Dhabi Investment Counsel (ADIC)). Additionally, the financial services sector has been deemed to be overserviced in the UAE (and wider Gulf Cooperation Council countries) with 73 listed banks in the UAE and Saudi Arabia serving a population just above 50 million. This has resulted in some recent major changes in this sector, with both mergers (e.g., the recently completed merger of First Gulf Bank and National Bank of Abu Dhabi to create First Abu Dhabi Bank and the proposed merger of Al Hilal Bank, Union National Bank and Abu Dhabi Commercial Bank) and consolidations of banks (e.g., Saudi British Bank and Alawwal Bank), as well as proposed mergers of other financial institutions and insurance companies.

Investor sentiment in the venture capital and technology space has remained strong as the UAE government recently announced incentives for entrepreneurs and tech companies and it has encouraged developments in the fintech space. The most notable venture capital deals in 2018 include a US$200 million investment in car-booking service Careem by Saudi Telecom Ventures, Al Tayyar Travel Group, Kingdom Holding and Rakuten, a US$120 million investment in Property Finder by General Atlantic with participation from Endeavor Catalyst and a US$30 million investment in Wadi.com by Majid Al Futtaim Ventures. While the UAE witnessed a number of venture capital deals, neighbouring Saudi Arabia hosted the largest tech transaction: the acquisition of a minority stake in Saudi Arabian electronic payment services firm Geidea by UAE-based private equity powerhouse Gulf Capital for US$266.67 million.

Fundraising activity in the region, particularly the UAE, was hit hard by the downfall of Abraaj, which started when some of its investors, including the Bill & Melinda Gates Foundation and World Bank Group’s International Finance Corporation, accused Abraaj of misusing investor money. The Abraaj situation further stifled what was already a difficult fundraising environment. Given the challenges, fund managers have had to become more creative when offering, and there have been bespoke fee structures and an increase in the popularity of the deal-by-deal approach to fundraising. This approach provides investors with more transparency and predictability and generally can be completed in a shorter time frame. Additionally, the deal-by-deal model generally features lower fees and expenses than would be featured in a larger blind-pool fund. While this method may be more labour-intensive from the perspective of a general partner, it generally results in a shorter fundraising period (as the amount being raised is smaller) and a shorter time frame for exit and payment of carry.

The slump in oil prices has taken a considerable bite out of the total market capitalisation as many of the companies listed on the stock exchanges in the UAE (NASDAQ Dubai, the Dubai Financial Market (DFM) and the Abu Dhabi Securities Exchange (ADX)) derive substantial revenues from oil production and related-energy industries. Stock exchanges in the UAE have recorded lower net profits over the past few years. In response to the new reality of decreasing oil revenues, the UAE has reformed its budget by cutting spending through a reduction in fuel subsidies and electricity subsidies. In Abu Dhabi, for example, electricity subsidies have been scaled back and water tariffs increased. To create additional income to cover the decrease in oil revenues, the government is imposing corporate taxes on onshore companies and implementing value added tax (VAT). The International Monetary Fund has hailed this decision, which it believes will strengthen the country’s fiscal position. It is not expected that taxes would be imposed on companies operating in a free zone in the UAE,
where most funds and investment managers are domiciled. Accordingly, it is not expected that the proposed taxes will have a substantial negative impact on the asset management industry in the UAE.

II LEGAL FRAMEWORK FOR FUNDRAISING

To be marketed onshore in the UAE, foreign funds (including funds established in the Dubai International Financial Centre (DIFC) and the Abu Dhabi Global Market (ADGM)) must be registered with the Securities and Commodities Authority (SCA) and offered by a licensed distributor unless the offer to an onshore investor is made on the basis of a reverse solicitation or the offer is made to certain sovereign-related entities or international bodies and organisations. Reliance on the reverse solicitation exemption is common place in the context of private equity fundraising in the UAE. In February 2017, Chairman Decision No. 3/RM of 2017 concerning Promoting and Introducing Regulations (PIRs) came into effect. Importantly, the PIRs expressly provide an exemption in relation to the promotion of foreign securities (including fund interests) onshore in the UAE based on a documented reverse solicitation. Foreign fund interests are otherwise generally not permitted to be promoted onshore in the UAE unless the promotion is to a qualified investor or the securities are registered with the SCA and an agreement with a locally licensed promoter is concluded.

On the other hand, in the DIFC and ADGM, there are no exemptions under the applicable securities laws that allow the marketing or offering of fund interests on a reverse solicitation basis. In the DIFC, a unit of a ’foreign fund’ (i.e., a fund that does not meet the following criteria: (1) a fund established or domiciled in the DIFC or (2) a fund established or domiciled in a jurisdiction other than the DIFC and is managed by a fund manager who is licensed by the Dubai Financial Services Authority (DFSA)) may only be offered or sold in or from the DIFC by a firm duly authorised by the DFSA to carry out those activities. Similarly, in the ADGM there is no reverse solicitation exemption and the marketing or offering of fund interests to investors in the ADGM may only be carried out by an entity licensed by the Financial Services Regulatory Authority (FSRA) to carry out that activity. Given the flexibility provided by the reverse solicitation exemption onshore in the UAE and the preponderance of investors being located onshore, it is commonplace for most fundraising to be carried out physically onshore in the UAE as opposed to in the DIFC or the ADGM.

There are few private equity investment funds that are domiciled onshore in the UAE. This is primarily due to an onerous licensing process (for both the manager and the fund) some concerns regarding the clarity and predictability of the legal regime, and the costs (relative to the DIFC and the ADGM). The ADGM was launched in 2015 to encourage foreign investment by offering foreign businesses attractive concessions and a number of investment incentives, including a zero per cent tax rate and the ability to own a 100 per cent subsidiary (foreign ownership restrictions apply outside the free zones). The ADGM is still in its infancy and is therefore not currently a preferred jurisdiction for investment funds. However, efforts are being made to help grow the jurisdiction as an asset management centre such as reductions in fees payable by firms looking to establish a presence in the ADGM. Private equity funds established in the DIFC, however, are more commonplace and are typically structured as investment companies and limited partnerships, both of which have separate legal personality under law. Private equity funds in the DIFC are generally established as either ‘exempt funds’ or ‘qualified investor funds’. Both classifications require that the fund be offered to professional clients only and the offering be made by private
placement only. The qualified investor fund regime was introduced to provide a lower cost and less regulated alternative to the exempt fund. Fund managers of qualified investor funds are exempt from many of the detailed requirements applicable to exempt funds. While exempt funds must have a minimum subscription amount per investor of US$50,000, qualified investor funds require a minimum subscription amount per investor of US$500,000. Until 18 December 2018, the DFSA imposed limits on the number of investors in the various categories of regulated funds (i.e., public funds had to have a minimum of 100 investors, exempt funds could have a maximum of 100 investors and qualified investor funds could have a maximum of 50 investors). These limits were recently abolished, giving managers additional flexibility when establishing and offering funds in the DIFC. Other amendments to the funds regime adopted in December 2018 include the concept of open-ended real estate funds and private REITs, which may be attractive to real estate private equity managers.

All UAE-based managers owe a level of fiduciary obligations to investors in funds that they manage. An SCA-regulated manager is required by law to manage the fund in a ‘manner that preserves the rights of the fund and its holders’. The manager may not obtain any ‘special gains or privileges’ from the fund other than the agreed disclosed fees. Additionally, the manager must ‘exert due care’ in the performance of all tasks. In the DIFC and the ADGM, the fund manager must, among other things, manage the fund, including the fund property, in accordance with the fund’s constitution and its most recent prospectus; perform the functions conferred on it by the fund’s constitution and applicable laws; and comply with any conditions or restrictions imposed by the DFSA or the FSRA (as applicable) including those on its licence or in respect of the fund. In exercising its powers and carrying out its duties a fund manager is required, among other things, to do the following:

- act honestly;
- exercise the degree of care and diligence that a reasonable person would exercise if he or she were in the fund manager’s position;
- act in the best interests of the unitholders and, if there is a conflict between the unitholders’ interests and its own interests, give priority to the unitholders’ interests;
- treat the unitholders who hold interests of the same class equally and unitholders who hold interests of different classes fairly;
- not improperly make use of information acquired through being the fund manager to gain an advantage for itself or another person; or
- not cause detriment to the unitholders in the fund.

These duties can be expanded in the fund’s constitutional documents. However, the relevant statutory duties cannot be reduced or removed.

III REGULATORY DEVELOPMENTS

Primary responsibility for overseeing the licensing, regulation and marketing of investment funds was transferred from the UAE Central Bank (the Central Bank) to the SCA, with the SCA confirming the implementation in the UAE of a ‘twin-peaks’ model of financial services regulation and supervision. Under this model, the Central Bank remains responsible for systemic stability, prudential oversight and monetary policy, while the SCA is responsible for conduct of business matters (including consumer protection and financial markets oversight). Any firm (whether based inside or outside the UAE, including free zones in the UAE) that intends to conduct investment management activities in the UAE outside a free zone must obtain a licence from the SCA. Any firm that is a financial service provider as defined in the Financial Services Act or any firm that is a fund manager, fund administrator or any person that is involved in the management of a fund must be licensed by the SCA. The SCA has established its own examination system to assess the competence of firms and their senior personnel. The SCA has also introduced a new set of regulations for non-UAE-incorporated funds that operate in the UAE as well as for UAE-incorporated funds. The SCA has also introduced a new set of regulations for non-UAE-incorporated funds that operate in the UAE as well as for UAE-incorporated funds. The SCA has also introduced a new set of regulations for non-UAE-incorporated funds that operate in the UAE as well as for UAE-incorporated funds.
zone must obtain a licence from the SCA prior to conducting those activities. In the DIFC and the ADGM, the DFSA and the FSRA respectively have regulatory authority over private equity funds and their managers in those jurisdictions. Fund managers are required to make accounts, records demonstrating compliance with the relevant laws and regulations, and delegation and outsourcing agreements available to the DFSA and the FSRA for inspection.

On 27 November 2018, the SCA and the regulators in the UAE’s two main financial free zones – the DFSA of the DIFC, and the FSRA of the ADGM – announced that they had reached an agreement to facilitate the licensing of funds domiciled in each other’s jurisdictions. While the agreement does not create a passporting regime across all products and services between the DIFC, the ADGM and the rest of the UAE, it implements a passporting regime for the promotion of domestic funds across the two jurisdictions. This announcement bolsters the efforts of each regulator in the area of investment funds and is expected to encourage the development of the domestic fund markets across the wider UAE.

Under the proposed new arrangements (which only apply to locally domiciled funds and do not apply to the marketing of foreign funds), DIFC-authorised firms that currently use an SCA-authorised distribution agent to distribute units of DIFC-based funds in the UAE outside the DIFC may decide instead to follow the proposed passporting regime and market and distribute the units themselves. A fund manager of a DIFC-domiciled fund can follow the passporting regime and, subject to satisfying certain requirements, the fund would then be registered by the DFSA, which will notify the other regulators, namely the FSRA or the SCA. The FSRA or the SCA will then include the fund on their own register of funds. Similarly, the FSRA issued a consultation paper outlining its proposed changes to the ADGM’s regulations and the FSRA rulebook. As with the DFSA’s proposed changes, the FSRA’s proposed amendments enable both public and private ADGM-domiciled funds to be registered for passporting through the same register of passported funds mentioned above, and to be marketed by an FSRA Authorised Person in either the DIFC or territory regulated by the SCA without obtaining an additional licence.

Historically, the UAE has been a tax-free jurisdiction. However, in October 2016, the UAE federal law establishing the UAE Federal Tax Authority (FTA) was issued. The FTA has been tasked with oversight over taxation in the UAE and, in particular, the implementation of the newly introduced VAT at a rate of 5 per cent, which became effective in January 2018. This has had an effect on advisers and managers of local funds as payments to local service providers are subject to VAT. Notwithstanding the introduction of VAT, the following taxes are not applicable in the UAE: withholding tax, corporate tax, personal income tax and capital gains tax. Oil, gas and petrochemical companies and branch offices of foreign banks are, however, required to pay taxes. Entities established in the DIFC and the ADGM and their employees are subject to a zero rate of tax (income tax, corporate tax, withholding, capital gains, etc.). It is not expected that the new proposed taxes will be assessed on free zone entities. Therefore, it is hoped that the tax regulations will have a negligible effect on the asset management industry in the UAE.

Additional developments that were welcomed in 2018 include the signing of memoranda of understanding between the Dubai Land Department (DLD) and each of the DIFC and the ADGM, pursuant to which DIFC and ADGM companies are permitted to own real estate in Dubai, subject to satisfying certain conditions and requirements. Historically, the DLD has limited types and jurisdictions of corporate vehicles that could own real estate assets in Dubai to (1) ensure legal and beneficial ownership of certain real estate assets were held only by UAE nationals and (2) enforce and simplify the collection of transaction fees
on direct and indirect transfer of real estate assets. DIFC or ADGM companies seeking to acquire real estate in Dubai must first obtain a non-objection certificate from the DIFC authorities or a certificate of incumbency from the ADGM authorities. The DIFC or ADGM authorities will be required to determine the direct and indirect shareholders of the applicant entity and will report to DLD with any changes to the shareholding structure and require the approval or non-objection of the DIFC or the ADGM in relation to the issuance or transfer of shares and payment of fees, with certain exceptions provided under specific circumstances.

IV OUTLOOK

Despite the challenges posed by geopolitical and global economic factors, stakeholders remain optimistic about the private equity terrain in the UAE. Against the backdrop of a financial downturn and the decline in oil prices that characterised 2017 and part of 2018, the UAE has shown its resilience. It has proved that its economy operates outside the oil and energy sectors, and that it has the infrastructure to maintain and grow its private equity and the wider asset management industry. The introduction of VAT in the UAE marks the implementation of a strategy aimed at augmenting and diversifying government revenues. Persistent low oil prices over the past three years has created an urgent need to diversify revenue streams through measures such as taxation. Regional and international participants in the venture capital and private equity arena see the UAE as the logical regional centre for their industries, with Dubai serving as the hub. In an effort to stimulate the investment funds industry, asset managers in the DIFC and the ADGM can now benefit from the newly introduced passporting regime, and real estate asset managers can start targeting onshore Dubai real estate assets for their various products. Fundraising is becoming more challenging with negative perceptions (particularly on the part of investors outside the region) of current regional geopolitical factors and following the recent collapse of Abraaj, long seen as the country’s leading asset manager. Consequently, general partners are continuing to explore alternative means of fundraising and limited partners are more willing to consider direct or co-investment options as preferred alternative to blind pool investing.
Chapter 22

UNITED KINGDOM

Jeremy Leggate, Prem Mohan and Ian Ferreira

I GENERAL OVERVIEW

The year 2017 was a record-breaking one for private equity fundraising, and it was uncertain whether 2018 could sustain both the pace and quantum of capital raised. Nevertheless, the first three quarters of 2018 saw more money raised than in any other year other than 2017. In aggregate, private equity fundraising fell in 2018 for the first time in three years, as 1,175 funds gathered US$435 billion in investor commitments, reversing a trend that has seen the number of private equity funds holding a closing diminish year on year (other than in 2017) for the past five years, but continuing the movement toward larger average fund sizes. In 2018, the average private equity fund size globally was US$363 million.

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 the mega buyout funds (defined by Preqin as raising at least US$4.5 billion), which together raised US$125 billion of the aggregate US$435 billion raised in 2018. As at the turn of 2019, approximately 3,750 private equity funds were seeking a combined US$977 billion in commitments, with the five largest mega buyout funds currently in the market seeking a combined US$219 billion (22.4 per cent of the aggregate targeted capital).

The European private equity fundraising landscape has largely mirrored these trends, with European-focused managers accounting for US$90 billion of aggregate capital raised in 2018, down from US$108 billion in 2017. Competition among managers, plus an increased caution among investors as nervousness about a potential market correction or other global financial market event meant fewer funds were oversubscribed. 2018 saw 39 per cent of private equity funds close above their fundraising target, the lowest percentage since 2014, although Europe's largest fundraising (EQT VIII at €10.75 billion) was almost 35 per cent above target.

As was the case in 2016 and 2017, 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 2018, with exit activity and the strong flow of distributions continuing, leading to investors having significant levels of capital to deploy. The larger, top-performing

1 Jeremy Leggate, Prem Mohan and Ian Ferreira are partners at Kirkland & Ellis International LLP.
2 Preqin.
3 Preqin.
4 Preqin.
5 Preqin. Note that this includes the SoftBank Vision Fund that held an interim closing in December 2018 at US$98.5 billion.
6 Preqin.
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 2018. Some 90 per cent of investors plan to maintain or increase their allocations to the asset class. However, as further evidence of the market disparity between the haves and have-nots, which we have consistently reported on since 2015, a survey by Probitas Partners found the percentage of investors planning to pursue relationships with new managers in 2019 fell to 27 per cent from 39 per cent in 2018. Dry powder continues to scale across all asset classes, with private equity managers holding approximately US$1.15 trillion in dry powder globally, and of this European-based managers account for US$241.3 billion, as at January 2019.

As the evidence above suggests, and in much the same vein as for 2017, investors are on the whole committing larger amounts of capital to fewer managers and generally seeking to consolidate their 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 Nordic regions have nevertheless seen a host of highly successful fundraisings in 2017. BC Partners, EQT, Equistone, Nordic, TDR and Triton all held closings for their latest funds in 2017, 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 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

7 'Fundraising Outlook: Caution Creeps in as Markets Flash Warnings', WSJ Pro Private Equity, 4 January 2019.
8 'Fundraising Outlook: Caution Creeps in as Markets Flash Warnings', WSJ Pro Private Equity, 4 January 2019.
9 'Europe Set for 2019 Fundraising Boost as Large Firms Return', WSJ Pro Private Equity, 4 January 2019.
10 Structures aimed at the retail market, such as VCTs, are not considered here.
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.\(^{11}\)

**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 fund raise 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

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11 ILPA 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’. 

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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.12

**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.13 These types of fees, and critically the full and accurate disclosure of such fees

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13 ILPA 2.0, ‘General Partner Fee Income offsets’. 

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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 today’s 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).

**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 a fund 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 (see above), 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 (MFN)**

The MFN 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 ILPA Private Equity Principles Version 2.0 published in
January 2011 – 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.

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.

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 in 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 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.

14 See http://ilpa.org/principles-version-2-0 for ILPA 2.0.
16 Section 89 of the FSA.
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 of the key executives and relevant experience;
- a market overview, so as 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, so as 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 AIFMD

The implementation of the AIFMD has altered the regulatory framework applicable to the marketing and management of private equity funds in the UK and the rest of the EU. The AIFMD broadly applies to managers under the following two circumstances: non-EU managers who intend to market a fund to investors in the EU; and EU onshore managers who 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 onshore 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

d certain portfolio company transparency, disclosure and ‘anti-asset stripping’ provisions aimed at preventing private equity firms from making distributions from portfolio companies acquired by the fund other than out of profits.

Additionally, regulators in the EU now require non-EU managers to register the fund that they intend to market in their respective jurisdictions 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.

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17 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.

18 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 the EU lawmakers complete the necessary steps to extend the passport on a voluntary basis to non-EU managers.

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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. 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). In implementing the AIFMD, the UK has chosen not to apply any gold-plated requirements to non-EU managers.

As a consequence of these new 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.19 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 other EU Member States may adopt a different interpretation of marketing, 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.

It is worth noting that 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.

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

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19 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 EEA.
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\(^\text{20}\) 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.

**PRIIPs**

After a delay of one year, 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 who 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

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\(^{20}\) Broadly, aggregate assets under management exceeding €500 million for unleveraged funds that do not have redemption rights exercisable during a period of five years from the initial investment in the fund; or €100 million for leveraged funds.
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, it is worth noting that following the implementation of the revised Markets in Financial Instruments Directive 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 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. However, the timetable for these events has become protracted, as the EU lawmakers have yet to complete the necessary steps to extend the passport on a voluntary basis to non-EU managers (see below).

On 30 July 2015, ESMA published its advice and opinion on the extension of the AIFMD passport to firms and funds established in non-EU jurisdictions. Of the six jurisdictions (United States, Guernsey, Jersey, Hong Kong, Singapore and Switzerland) it shortlisted for this assessment, ESMA concluded that only Jersey, Guernsey and (subject to certain legislative amendments being enacted) Switzerland presented no significant obstacles to the extension of the AIFMD passport. For a variety of reasons, ranging from a lack of detailed information on the extant regulatory regimes to concerns around the absence of a level playing field for EU managers and funds, ESMA advised the EU lawmakers to delay their decision on the extension of the passport to Hong Kong, Singapore and United States. ESMA also advised the Commission against taking any legislative steps to extend the passport until it delivered positive advice on a ‘sufficient’ number of non-EU countries.

Subsequently, on 19 July 2016, ESMA published its second advice on the extension of the AIFMD passport, assessing 12 non-EU jurisdictions in total. ESMA issued positive advice with respect to the extension of the passport to Canada, Guernsey, Hong Kong, Japan,
Jersey, Singapore and Switzerland. ESMA issued caveated opinions with respect to Australia and the United States. With respect to Australia, ESMA did not identify significant obstacles to the application of the AIFMD passport, provided that the Australian Securities and Investment Committee extended to all EU Member States the ‘class order relief’ from some requirements of the Australian regulatory framework. With respect to the United States, ESMA concluded that there were no significant obstacles for funds marketed by managers to professional investors that do not involve any public offering. However, ESMA noted that where marketing a fund to professional investors involved a public offering, a potential extension of the AIFMD passport to the United States would risk creating an unlevel playing field between EU and non-EU AIFMs. ESMA suggested EU lawmaker consider options to mitigate this risk. ESMA did not issue any definitive advice with respect to Bermuda, the Cayman Islands and the Isle of Man.

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 ESMA’s advice.

**Proposals to amend the AIFMD**

In March 2018, the European Commission published certain legislative proposals to amend (among other matters) certain provisions under the AIFMD relating to the cross-border distribution of investment funds. The key changes under these proposals 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;

b) imposing new requirements on both EU and non-EU managers who seek to market investment funds to retail investors;

c) 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

d) harmonising the basis on which charges are levied by EU regulators, and increasing the transparency around such charges.

These proposals are currently being considered by the EU lawmaking institutions, in consultation with industry bodies and other stakeholders. In view of present progress on these proposals, the amended rules are likely to become applicable to managers in the course of 2021. Managers who may be impacted by these proposals continue to monitor developments.

**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). Accordingly, the UK will cease to be a member of the EU from 11 pm, 29 March 2019.

At the time of writing, it is not clear what the terms governing the UK’s departure will be, or whether there will be a transitional period from 29 March 2019. If the UK departs the EU on that date without a withdrawal agreement and transitional arrangements in place, 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 transitional or other 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 addition, UK managers seeking to register for marketing in a particular EU jurisdiction would have to ensure that, pursuant to the AIFMD, the FCA has entered into a memorandum of understanding with the financial services regulator in that EU jurisdiction.

In the UK, the FCA has been making 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 once the UK leaves the EU. 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 complying with certain notification requirements. The notification window for this temporary permissions regime has had to be extended following the delay to the UK’s withdrawal process and, at the time of writing, is set to close at the end of 30 May 2019; however, this date remains subject to review.

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.

T
ax 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 (although see below for developments in this area). 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 see below for current developments in this area relating to certain ‘long-term’ UK-resident non-domiciled individuals.
However, there are now 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 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 new 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 new rules have not, however, displaced 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, at the level of 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.

More generally, the impact of the Organisation for Economic Co-operation and Development base erosion and profit shifting (BEPS) project, and of the EU anti-abuse directives, ATAD I and ATAD II, are 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.

In addition, the structuring of management fees through a priority profit share is likely to be less common going forward, following changes that came into effect in April 2017 in the UK restricting the amount of carried forward losses a company can utilise for corporation tax purposes; instead we are likely to see, subject to appropriate regulatory and VAT planning, fund partnerships appoint, and pay management fees directly to, their manager. This structure may impact UK taxpaying investors in the fund (including members of the management team).

From 30 September 2017, the UK corporate-level criminal offence of ‘failure to prevent the facilitation of tax evasion’ also added to compliance and regulatory workloads.

Looking forward, there are a number of developments and challenges. New rules bringing non-UK residents into the charge to UK capital gains tax on the disposal (both direct and indirect) of UK commercial real estate come into force in April 2019, and these represent a significant change for funds (and their investors) investing in UK real estate. The EU mandatory disclosure regime, which entered into effect on 25 June 2018, adds to the compliance burden 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). So, notwithstanding the fact that (at the time of writing) local implementing legislation has yet to be made available, procedures for information gathering and reporting should be put in place by affected parties now. Pending partnership tax reform, and EU Member States’ implementation of the ATADs, are items to watch carefully as we progress through the year.

**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 poor performance of certain managers as well as the increased competition for commitments to the top-performing managers continues to increase traffic in secondary sales and transfers of partnership interests.
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.

The outlook for private equity fundraising in 2019 is, in the main, positive. This is driven by the large number of firms either planning to raise a fund or actively marketing one. The industry is increasingly driven by the larger managers’ timing, and target fund sizes, and after the likes of Apollo, CVC, KKR and TPG all closed funds in 2017, just three managers closed funds in 2018 at figures above 10 billion (Carlyle Partners VII at US$18.5 billion, Hellman & Friedman Capital Partners IX at US$16 billion and EQT VIII at €10.75 billion). Several more large managers can be expected to raise funds in 2019. Although investor appetite for smaller funds still exists, concerns regarding a market correction mean that the bifurcation of the fundraising market between smaller and larger managers is only likely to become more pronounced.21

21 Christopher Elvin, Preqin, 2018 Fundraising Update.
Chapter 23

UNITED STATES

Kevin P Scanlan

I GENERAL OVERVIEW

Given the continuing excellent performance of the private equity fund industry, private equity fundraising has been very strong. This performance has resulted in increased demand for private equity funds and has enhanced fund managers’ ability to raise capital for their funds. For instance, based on a recent Preqin report, funds seeking to be the largest-ever private equity, venture capital, real estate, infrastructure and secondaries funds are currently in the market. Further, this trend does not seem likely to abate in 2019. Based on that same report, large proportions of investors in every private capital asset class indicated they expect to commit more capital in 2019 than they did in 2018. This illustrates not only the vibrant market for deploying capital and disposing of investments, but also the strength of the fundraising market. However, the capital is not being invested by investors evenly across all funds. The capital raised is increasingly concentrated in funds managed by larger fund managers. In this regard, billion-dollar funds represented two-thirds of all capital raised in

1 Kevin P Scanlan is a partner at Kramer Levin Naftalis & Frankel LLP.
2 Based on a Cambridge Associates report summarising the performance of venture capital and buyout and growth equity funds up to 30 September 2017, venture capital funds reported a five-year net internal rate of return of 14.76 per cent while buyout and growth equity funds reported a five-year net internal rate of return of 14.14 per cent. These numbers reflect the performance of over 2,000 fund managers so the results of funds in the first quartile are likely to be significantly higher. Based on a separate report issued by Cambridge Associates as at 30 September 2018, the year-to-date return of venture capital funds and global growth equity funds it tracks was 18.07 per cent and 19.37 per cent, respectively.
3 For purposes of this chapter, when we refer to ‘private equity funds’, we are referring to closed-end funds in which the capital invested by the investors is contributed periodically upon the request of the fund manager pursuant to a binding commitment to fund (i.e., a capital commitment) that was made by the investor at the time of investing. Although these funds may invest in different types of investments and operate different strategies (e.g., venture capital, growth equity, buyout and credit-related strategies such as mezzanine and direct lending), the capital raising process and regulatory considerations are generally identical and we will refer to all types of such funds under this rubric as private equity funds.
4 See Preqin 2018 Fundraising Update, page 2.
5 Id.
2018, and most of the largest fund managers indicated that they are routinely oversubscribed. 6 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, in part because of the less developed case law around limited liability companies given the statute is relatively new and more significantly because 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 partly because of 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

6 Id. at page 4. This consolidation movement continues from 2017, during which investors indicated that they wished to consolidate their investments with a smaller number of fund managers to negotiate a better fee structure, gain access to co-investment opportunities and reduce the operational costs associated with managing investments with a large number of fund managers. PitchBook’s 2017 Annual US PE Breakdown, page 14.
fund (particularly for fund managers that are not already subject to these obligations) can be quite extensive. As a result, fund managers seeking to receive capital commitments from these investors generally will have 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 United States, 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 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 out 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 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 issues concerning the portability of the track record (e.g., whether 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), whether the manager has sufficient supporting documentation to justify the use of the track record, whether the new private equity fund’s strategy is substantially similar to the strategy that generated the prior track record and whether all the material assumptions associated with the track record are set out 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 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:

> unless 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.\(^7\)

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 out 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,\(^8\) (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 the 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 out in Rule 506(d) of Regulation D. These rules

\(^7\) Section 5 of the US Securities Act of 1933.

\(^8\) Very generally, accredited investors are natural persons with a net worth (excluding the value of their primary residence) of US$1,000,000 and entities with total assets of US$5,000,000.
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 persons9 have had a disqualifying event10 in the past.

**Manner of offering**

One of the more significant requirements of Rule 506(b) is the prohibition on general advertising and solicitation.11 Essentially, this requires that the fund manager must have a substantive pre-existing relationship with a potential investor to solicit that 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 (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 the 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 that person is registered with the SEC as a broker-dealer or an exemption from this 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

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9 Although the list of covered persons is too long to set out 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 a pooled investment vehicle.

10 Disqualifying events include, among other things, criminal convictions, final orders of certain state and federal regulators, SEC disciplinary orders and SEC stop orders.

11 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.
disqualification from acting in that 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.

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 above (see footnote 7), 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 the United States when such offers and sales are made with only incidental US contacts and are made in a way reasonably 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 transaction12 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, or ILPA.13 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.

12 An offshore transaction is a transaction in which the offer or sale of the fund’s interests is made to a person outside the United States and the buyer is offshore at the time of the origination of the buy order.
13 See https://ilpa.org/best-practices/overview-and-history/.
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 the 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 out 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 out 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 its beneficial owners must be 'qualified purchasers'.14 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 is likely to fall within the definition of an investment adviser15 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 funds16 and that has less than US$150 million

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14 The definition of a qualified purchaser is set out 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.

15 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.

16 A private fund is defined as any issuer that would be an investment company under the Investment Company Act but for the exceptions set out in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.
in regulatory assets under management\textsuperscript{17} in the United States. For US-based investment advisers, all 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 the United States (a non-US adviser), the exemption is available as long as all the non-US adviser’s clients that are US persons are ‘qualifying private funds’\textsuperscript{18} 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.

\textbf{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.

\textbf{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,\textsuperscript{19} 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,  

\textsuperscript{17} 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.

\textsuperscript{18} 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.

\textsuperscript{19} 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.
other than ‘qualifying investments’ or short-term holdings, no more than 20 per cent of the amount of the fund’s aggregate capital contributions and uncalled committed capital (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 probably have 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 the 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 the 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 consider whether it is required to register with the CFTC as a commodity pool operator (CPO) or a commodity trading advisor (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 out 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

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20 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 the 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.
positions, 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 out 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 to engage in the trading of commodity interests on US exchanges, 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 the United States, (2) the private equity fund and its investors must all be located outside 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 out 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 the 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 probably will be required to register with the CFTC in this capacity. This generally will mean that the fund manager will have to operate each private equity fund it manages that is outside any applicable CFTC exemption pursuant to CFTC Rule 4.7. CFTC Rule 4.7 can only 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.

21 To meet the \textit{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.

22 Qualified eligible persons include, among other categories of investors, qualified purchasers.
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 that such compensation 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.

IV OUTLOOK

The private equity fund industry has been through a great deal in the past 10 years or so. There has been a financial crisis in 2008 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 seem to be thriving given a strong investment environment. At the current time there is a high degree of demand for their investment advisory services, and their funds generally are becoming larger and are closing on capital commitments at a historically fast pace. This does not look to change, at least in the near term. Given the recent volatility in the public markets, investors may continue to flock to private equity fund strategies to diversify the risk associated with their holdings of public securities.
Part II

INVESTING
Chapter 1

AUSTRIA

Florian Cvak and Clemens Philipp Schindler

I OVERVIEW

i Deal activity

Investments

Private equity activity was robust throughout the year. In the large-cap sector (comprising deals with values above €100 million) deal count and average deal values increased compared to 2017. The most prominent large-cap transaction of 2018 was the acquisition by Advent of the distributed power business of General Electric, including manufacturing sites in Austria, Canada and the United States, with a reported deal value of €2.78 billion; followed by the acquisition by Capvis and Partners Group of a majority stake in Amann Girrbach AG, an Austria-based manufacturer of laboratory equipment for dental technicians and dental laboratories, from TA Associates for an undisclosed consideration reportedly in the region of €1 billion; the acquisition by Starwood Capital Group of a 26 per cent stake in CA Immobilien Anlagen AG, a listed Austria-based company engaged in the purchase, management and development of real estate, from Immofinanz AG with a reported deal value of €758 million; and the acquisition by Sun Capital Partners of ESIM Chemicals GmbH, an Austria-based company that provides agricultural and crop protection chemicals, intermediates, and anhydride tree chemicals, from Ardian for an undisclosed consideration reportedly in the region of mid-three-digit millions of euros.

In the mid-cap sector (comprising deals with values of between €10 million and €100 million) deal count and average deal values remained more or less on a par with 2017. Examples of mid-market deals include the acquisition by HÖR Technologie GmbH, a portfolio company of VR Equitypartner GmbH, of Pichler & Strobl GmbH, an Austria-based high-tech components company; the acquisition by VR Equitypartner GmbH, of APZ Auto-Pflege-Zentrum GmbH, a car refurbishment business with activities in Germany, Austria and Luxembourg; the acquisition by DPE Deutsche Private Equity GmbH, of a 70 per cent stake in VTU Holding GmbH, an Austria-based engineering company; the acquisition by Invest AG and Raiffeisen KMU Beteiligungs AG, of Bilfinger Geräteotechnik GmbH; the acquisition by IMCap Partners AG of a majority stake in Intact GmbH, an Austria-based enterprise-resource-planning software provider; the acquisition led by Invest AG of a 75 per cent stake in e-tec electronic GmbH, an Austria-based retailer of electronics; the acquisition by GBA Gesellschaft für Bioanalytik mbH a portfolio company of Quadriga Capital, of a majority stake in Hygienicum Institut für Mikrobiologie & Hygiene-Co, an Austria-based company that provides laboratory and consulting services;

1 Florian Cvak and Clemens Philipp Schindler are partners at Schindler Attorneys.
and the acquisition by aws-mittelstandsfonds Management GmbH along with management, of AMI Agency for Medical GmbH, an Austria-based company engaged in developing and manufacturing medical products and surgical equipment.

Venture capital activity (comprising deal values of €5 million and above) significantly increased compared to 2017 in terms of deal count, and more than doubled in terms of deal volume. The most notable investment was the Series C round led by Technology Crossover Ventures for TourRadar GmbH, an Austria-based operator of an online marketplace for group travel, with a reported deal value of €43 million; followed by a Series B round led by Highland Europe for Bitmovin Inc, an Austria-based developer of cloud-based video workflow solutions, with a reported deal value of €26 million; and a round led by eQventure for Usound, an Austria-based producer of speaker systems, with a reported deal value of €17 million. In addition, there were two rounds with a deal value of around €17 million and a handful of rounds with deal values in the region of €5 million.

**Exits**

Private equity (PE) exits were outnumbered by PE investments in 2018, and average deal values in PE exit transactions were also lower. The only notable exit in the large-cap sector (comprising deals with values above €100 million) was the sale by Bridgepoint of AHT Cooling Systems GmbH, an Austria-based manufacturer of fridges and deep freezers for supermarkets, ice cream freezers and drink cooling systems, to Daikin Industries, Ltd. with a reported deal value of €881 million.

In the mid-cap sector (comprising deals with values of between €10 million and €100 million) notable PE exits included the sale by CornerstoneCapital AG of a majority stake in Infoniqa Payroll Holding GmbH to Elvaston Capital Management GmbH; the sale by NORD Holding of a qualified minority stake in Lenzing Plastics GmbH & Co KG to Invest AG (with deal values not disclosed but rumoured to have been in the upper half of the two-digit millions of euros); the sale by eQventure along with the founders of NEXTSENSE GmbH, an Austria-based metrology business, to Hexagon AB with a reported deal value of €43 million; the sale by Quadriga Capital of Alicona Imaging GmbH, an Austria-based optical quality assurance business, to Bruker Corporation (deal value not disclosed); the sale by TecNet Equity and Speed Invest of a majority stake in Sipwise GmbH, an Austrian developer of core cloud communication solutions, to Alcatel Lucent (deal value not disclosed); and the sale by Invest AG of a majority stake in TTI Personaldienstleistung GmbH & Co KG, an Austria-based management and recruitment company and provider of consultancy services (deal value not disclosed).

**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 offered the opportunity (and is sometimes even required) to acquire an interest in the target to ensure their commitment. 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 asked (or given the opportunity) to participate on a 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 jurisdictions 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 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:

- 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
- 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 expired. If the tax group

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2 For acquisitions made until 28 February 2014, Austrian tax law also provided for goodwill amortisation on share deals involving an Austrian operational target (based on case law, this was extended to EU-resident targets). As this regime is no longer available, foreign bidcos are increasingly employed.

3 Historically, the equity was channelled down to Austria by way of indirect grandparent capital contributions to avoid capital tax (which would have been triggered in the case of a direct parent capital contribution). Capital tax on direct capital contributions was, however, abolished, with effect from 1 January 2016.
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 of these points is often of great interest to the financing banks, 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 of the management board), 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 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 is 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 to 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** 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);
- **b** a duty of loyalty, requiring members to act in the best interest of the company and its shareholders and not in their own interest;
- **c** a duty of confidentiality; and
- **d** 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). Leverage levels for large-cap transactions increased slightly but are still
in the range of 6x EBITDA. Small to mid-cap transactions are frequently financed equity only. Leverage levels and relative debt-to-equity ratios generally tend to be lower for small to mid-cap transactions than for large-cap deals.

Where leverage is employed on small and 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, separate junior debt is often added to the mix. Unitranche facilities are gaining ground (the most recent example being the Schweighofer Fiber transaction). High yield on the other hand, is of little significance in practice as the time and cost involved tends to be disproportionate to the gains on the pricing side. High yield does, however, play a role in post-completion refinancing.

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 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

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 minimum 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:
  • shareholders holding qualified participations in the AIFM (i.e., shareholdings exceeding 10 per cent);
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 on which it manages its AIFs.

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**

As mentioned above, 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**

A couple of larger auctions involving assets that should attract PE interest are expected in 2019, but not at the level of 2018. In the mid-cap sector, technology, and industrial products and services, are expected to be hot again. The real estate sector is also forecast to remain relatively strong but not on a par with 2017 and 2018. Venture capital activity is expected to increase again on the back of a very robust 2018 and increased appetite from US funds for investing in Austria-based startups, which historically was the exception.
I OVERVIEW

Deal activity

In the past few years, economic growth slowed in Brazil 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. This scenario, however, seems to be changing with the recent election of the right-wing President Jair Bolsonaro. A positive, yet cautious, sentiment has possessed investors with the recent election of a far-right candidate after more than a decade under a left-wing government marked by corruption and fraud scandals. In the first days of Bolsonaro’s government, the stock exchange index Ibovespa rose and the US dollar registered a significant decrease, suggesting a positive movement in Brazil’s political and economic landscape.

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 strengthened Brazil’s currency, the real, against the US dollar. Investors are now awaiting the implementation of the new government’s proposals, especially the reform of the costly pension system.

Although the real has experienced a smooth appreciation in the past few years, the currency’s hefty devaluation in previous years, along with Brazil’s competitive potential and vast market, means the country remains an attractive destination for international private equity investment.

Not surprisingly, 2018 saw signs of a potential effective economic recovery, with an increase of 4 per cent in the number of mergers and acquisitions (M&A) between January and October, compared to the same period in 2017. The growth was most noticeable in the areas of information technology and financial and public services.²

On the other hand, because of market instability produced by the presidential election, there were only three initial public offerings (IPOs) in 2018,³ a significant decrease from

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1 Marcus Vinicius Bitencourt, Alex Jorge and Luiz Augusto Osório are partners and Marcelo Siqueira, Camila Caetano Cardoso and Laura Angrisani are associates at Campos Mello Advogados in cooperation with DLA Piper.


3 Information available at www.bmfbovespa.com.br.
2017, when 10 companies went public. Nonetheless, according to the CEO of B3, to up to 30 Brazilian companies could be ready to go public in 2019, once the newly elected president’s proposed reforms have been passed in Congress.

In terms of total investments, data from the Brazilian Association of Private Equity & Venture Capital (ABVCAP) and KPMG indicates that private equity investment in Brazil during 2017 amounted to approximately US$3.93 billion, an increase of 34.5 per cent compared with 2016. Also, the number of companies that invested in Brazil was considerably greater, rising from 157 in 2016 to 175 in 2017. The average investment amount was US$22.45 million. Analysis of the transactions carried out in 2017, compared with 2016, shows a significant level of investment in the infrastructure sector, representing 21 per cent of the total amount invested in 2017. The education, energy, and food and beverage sectors were also much in demand, representing, jointly, 37 per cent of private equity investments made in 2017.

The same study by ABVCAP and KPMG indicates a substantial growth in divestment transactions in Brazil in 2017, amounting to US$2.6 billion – 103 per cent higher than the US$1.2 billion recorded in 2016.

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 Brazilian Securities Commission (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 this book covers other jurisdictions individually, 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 manager, and an administrator that must be a financial institution authorised to function by the Central Bank. The manager exercises the most relevant function, as it is directly responsible for managing the portfolio, including investment and divestment decisions. It is important to note that the administrator and the manager can be the same entity.

4 B3 S.A. – Brasil, Bolsa, Balcão is the securities, commodities and futures exchange operating in Brazil, which resulted from the merger of BM&FBOVESPA S.A. Securities, Commodities and Futures Exchange with Cetip S.A. – Mercados Organizados in March 2017.
7 These monetary values have been converted from Brazilian reais to US dollars at the exchange rate for 31 December 2018, as published by the Brazilian Central Bank.
8 Percentages calculated on the amounts in Brazilian reais.
9 See footnote 6.
10 See footnote 6.
11 CVM Instruction No. 558/15, in force since 4 January 2016, regulates activities related to securities portfolio administration.
According to data published by the Brazilian Association of Financial and Capital Market Entities (ANBIMA),\(^{12}\) in November 2018, the largest private equity fund managers in Brazil in terms of assets were BB DTVM SA, Bradesco, 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.\(^{13}\)

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.

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


\(^{13}\) Information from an ABVCAP report in partnership with Insper.
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 equity investment funds (FIPs) and are subject to the regulations of the CVM.14

FIPs must invest their assets in shares, subscription warrants, debentures and other securities convertible into or exchangeable for shares of corporations, both listed and unlisted, as well as securities that represent quotas of 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 than 15 per cent of the company’s corporate capital; or if the book value of the investment is reduced to zero.

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

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 one year for all directors; they must disclose 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.
of the Brazilian Central Bank.\(^{16}\) 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\(^ {17} \) is currently taxed at zero per cent,\(^ {18} \) provided that the following requirements are met:

\( a \) the non-resident investor\(^ {19} \) 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)\(^ {20} \) or does not have the right to receive 40 per cent or more of the total income generated by the fund (the economic test);

\( b \) 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 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 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,\(^ {21} \) 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

\(^ {16} \) Resolution No. 4,373 of 29 September 2014, issued by the National Monetary Council.

\(^ {17} \) 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 (RFB).

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.

\(^ {18} \) Section 3 of Law No. 11,312/2006.

\(^ {19} \) The FIP may also have Brazilian resident investors, but they will not benefit from this tax incentive.

\(^ {20} \) 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.

\(^ {21} \) Section 97 of Law No. 12,973/2014.
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, 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.

It is also worth mentioning that, as of 27 December 2018, recent amendments introduced by the Brazilian Federal Revenue (RFB) in Rule No. 1,863 (IN 1,863/2018), 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, defined, with a few exceptions, as the (1) the individual or individuals who either

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22 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).

23 This obligation was also imposed on Brazilian entities by COCAD Declaratory Executive Act No. 9, of 23 October 2017, issued by the RFB.
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 the absence of such an update, by 26 June December 2019 (180 days from the publication of IN 1,863/2018).

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.

As a complement to the CVM rules, 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.

III YEAR IN REVIEW

Recent deal activity

Despite economic and political instability in 2018, important deals were carried out during the year. Notable among these was the launch of the first Brazilian ‘unicorn’ (the term for start-ups valued at over US$1 billion) when Chinese company Didi Chuxing acquired the Brazilian mobile phone taxi-hailing application developer 99 Taxis.

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24 Pursuant to Article 8, Section 2 of RFB Rule No. 1,634, as of 6 May 2016 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.

25 CVM Instruction No. 558/15, in force since 4 January 2016, regulates activities related to securities portfolio administration.

26 ABVCAP–ANBIMA’s Regulation and Best Practices Code: Private Equity and Venture Capital Funds.
PagSeguro, a Brazilian payments company, also surpassed the US$1 billion valuation, becoming the biggest public listing of a Brazilian company when its launch on the New York Stock Exchange raised US$2.6 billion. PagSeguro’s stock increased by 35.8 per cent on its first day of trading – an appreciation that saw the company achieve a stock market valuation of US$8.99 billion.

Nubank, a Brazilian credit card start-up, has also qualified as a Brazilian unicorn, becoming the biggest start-up in Latin America, with investment provided by the Chinese company Tencent.

Among other important transactions carried out in 2018, the global private equity fund Advent International acquired a majority stake of 80 per cent in Walmart Brazil, the third-largest food retailer in Brazil. Also in 2018, leading global private equity firm HIG Capital, which specialises in investments in medium-sized companies and has more than US$27 billion of capital under management, acquired Tecfil, Brazil’s largest automotive filter manufacturer. Tecfil serves the replacement market for the light and heavy vehicle industries in Latin America.

Standout investments were also made by Aqua Capital, a Brazilian private equity firm focusing on growth investments in mid-market companies in South American agribusiness and in Brazil in particular. Throughout the course of 2018, it invested approximately US$100 million in six companies, most of them engaged in the distribution of commodities.27

Another type of investment progressively gaining strength in Brazil is the practice of corporate venture capital (CVC), which consists in the investment by well-established institutions in early-stage companies outside the corporate chain of the investing company. The main purpose of CVC is to develop a product or a specific market without having to establish an internal ‘project and development’ department, which, at times, may prove more time-consuming, demanding and costly than investment 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.

Embraer SA, the Brazilian business conglomerate that manufactures commercial and military aircraft, among other things, is one example of CVC in practice in Brazil. In 2013, Embraer was one of the first Brazilian companies to launch a CVC FIP to invest in early-stage companies mainly located in Silicon Valley and with a focus on the aerospace sector. This CVC FIP has the Brazilian National Bank for Economic and Social Development as one of its shareholders. The bank Bradesco also has a corporate venture programme in Brazil, named InovaBRA, which consists in a FIP that invests in start-ups, and which performs actively as a minority shareholder through participation on boards of directors and mentoring. Other Brazilian companies from various sectors of the economy – including banking (BB, BMG, Itaú, Santander), industry (Gerdau, Natura, Votorantim) and retail (Pão de Açúcar, Magazine Luiza) – also invest in early-stage companies for the purpose of generating business innovation.

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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 the following: FIPs are now able to invest in limited liability companies and in non-convertible debentures; they can invest up to 20 per cent of their net equity in offshore private equity assets; and they can 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 FIP: Seed Capital, which allows the use of a FIP under certain conditions, as a vehicle to invest in start-up companies. Furthermore, the administrator may create different classes of quotas, 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.

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.

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28 Although CVM Instruction No. 578 was enacted in August 2016, the FIPs had until August 2017 to adapt the new rules.

29 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.

30 CVM Instruction No. 579 applies to accounting periods initiated on or after 1 January 2017.
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.31

iv Exits

Outbound transactions carried out in the past year were low on account of the political scenario and instability in the Brazilian market, with it being more difficult to define prices and meet market demand. The estimate of divestment for 2018 is around US$903 million, whereas the year before saw an exit record of US$2.5 billion.32

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. Now, Carlyle Group intends to launch the IPO of the company and use the funds raised to open new stores. The IPO was scheduled for 2018 but was postponed because of low demand from investors. The expectation is that Carlyle Group will resume the listing of Ri Happy in 2019.

Divestments transactions are expected to pick up at the beginning of 2019.

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.

Besides 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.

31 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.

V OUTLOOK

In light of the above, companies, financial institutions and investors are waiting for the implementation of the proposals submitted by the new Brazilian government, which would 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 of the economy, especially in Brazil’s infrastructure, given the potential for privatisation of state-owned companies.

The private equity investment environment has also been continuously modernising and adjusting to the reality of the 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.

There are 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 thus necessary to retain specialist advisers before investing in Brazil.
Chapter 3

CANADA

Michael P Whitcombe and Charles Chevrette

I  OVERVIEW

i  Deal activity

Canada remains highly ranked by a number of sources as an attractive country for foreign financial actors to invest in, particularly US private equity investors.

Canada has competitive corporate tax rates, established public markets, an educated and diverse labour force, a need for significant infrastructure investment and a modern legal system. Those factors, coupled with the low Canadian dollar, should have created favourable conditions for private equity activity in Canada. However, it is often noted that the significant financial resources of a number of Canadian pension plans and their investment focus on major infrastructure projects outside Canada, has resulted in Canada being a ‘net exporter’ of investment capital.

While there have been a few Canadian private equity transactions exceeding C$1 billion in enterprise value in the first three quarters of 2018, most Canadian transactions were in the C$25 million–500 million range.

As of Q3 2018, the total private equity investment in Canada presents a 24 per cent decline from the 2017 level, with a year-to-date total of C$16.5 billion (over 415 deals) compared to C$26.4 billion (over 613 deals) in 2017.

As of Q3 2018, the small end of the market segment (deals of less than C$25 million) garnered 68 per cent of all deals for a total value of C$1.324 billion, up by 8 per cent from 2017, and deals of between C$25 million and C$100 million captured a 6 per cent share, for a total value of C$1.316 billion, down from 11 per cent in 2017. Deals in the C$100 million–500 million range produced a total value of C$3.282 billion, and there was one deal in the C$500 million to C$1 billion range (as opposed to 11 deals in 2017) for a value of C$509 million. It is worth noting that 2018 was marked by an important decline in the number of private equity (PE) transactions in the C$500 million to C$1 billion range.

There were two deals over C$1 billion in the first three quarters of 2018, which accounted for 61 per cent of the funds invested, the largest being the C$5.1 billion recapitalisation of Ontario-based GFL Environmental Inc by an investor consortium that included the Ontario Teachers’ Pension Plan in Q2 2018. The other transaction was the C$5 billion secondary buyout of Husky Injection Molding Systems Ltd in Q1 2018.

1  Michael P Whitcombe and Charles Chevrette are partners at McMillan LLP.
2  Unless otherwise indicated, data provided here is sourced from S&P Capital IQ and the Canadian Venture Capital & Private Equity Association.
As was the case in 2017, the most active sector of all transactions was the industrial and manufacturing sector (95 deals), which, as of Q3 2018, had seen almost one-fourth of all private equity transactions. This was followed by the information and communications technology sector with 15 per cent of all transactions (63 deals). The industrial and manufacturing sector also received the largest share of funds invested, with C$5.967 billion, followed by the clean technology sector, which received total investments of C$5.234 billion for the same period.

The pace of private equity exits slowed significantly, with only 61 exits as of Q3 2018, less than half the number of exits throughout 2017.

**Trade sale**

M&A continued to be the primary exit vehicle for PE firms in the first three quarters of 2018, with 53 exits totalling C$1.649 billion, a significant decrease from the 137 exit transactions by way of M&A in 2017, representing C$3.1 billion in exit value.

**Secondary sale**

As of Q3 2018, secondary sales represented nearly half of the total exit value of C$11.3 billion. The Canadian Venture Capital & Private Equity Association reported four exits by way of secondary sales by private equity investors for the first three quarters of 2018, representing approximately C$5.2 billion.

**Initial public offering**

Initial public offering (IPO) activity for private equity-backed companies, which had shown renewed activity in 2017, continued to grow in 2018, with four IPOs, including the US$153 million IPO of British Columbia-based Tilray on NASDAQ, and the C$709 million listing of Quebec-based IPL Inc on the TSX.

**General comments**

The year 2018 showed a strong decline compared to 2017, with, as of Q3 2018, a total of 415 deals for a total amount of C$16.5 billion. While the number of deals is consistent with the data recorded as of Q3 2017 (447 deals), there was a decline in total deal value in comparison to the investments made in the first three quarters of 2017 (C$21.7 billion). Only C$1.9 billion (the lowest amount since Q3 2013) was invested in private equity deals in Q3 2018.

By contrast, the total value of announced buyouts of Canadian companies by private equity firms amounted to C$65.5 billion in 2007, which remains Canada’s tipping point. That said, this total was skewed by the mega C$46.8 billion buyout of BCE Inc (which never closed).

We are experiencing an increase in the number of family office and sovereign wealth funds participating in this sector, in addition to investors from China and the Middle East. Three of the most active Canadian sponsors in 2018 are from Quebec: Fonds de solidarité des travailleurs du Québec (127 deals), Capital régional et coopératif Desjardins (78 deals) and Caisse de dépôt et placement du Québec (27 deals). Other significant Canadian private equity funds include Onex Partners, Novacap Investments and Birch Hill Equity Partners.
There are hundreds of US private equity funds investing in Canada in any given year, including some of the largest US funds, such as Bain, TPG and Oaktree.

We are not aware of any sponsors who have left the jurisdiction.

ii Operation of the market

Many equity incentive tools are available in Canada to compensate management, including stock options, stock purchase plans, stock appreciation rights and deferred stock units. Traditional stock options are the most popular incentives as they are not subject to taxation until exercised and, subject to complying with certain rules available to employees, are eligible for a capital-gains equivalent tax rate.

Often, management sellers will be offered the opportunity to maintain a minority equity interest in the acquired entity. The terms and conditions of the minority interest will often require extensive negotiations between the parties. In these circumstances, private equity sponsors typically favour structures involving dual classes of equity with one reserved for themselves and having priority over the class intended for the continuing management. Depending on the terms surrounding the issue of the equity to continuing management, the return enjoyed by management may be conditioned on a minimum threshold return to the private equity sponsor. Both commercial and personal tax considerations impact the preferred equity structure for any particular transaction.

Options granted under a Canadian stock option plan will generally vest during the continued employment over a period, or upon the fulfilment of certain performance conditions such as revenue growth or bottom line financial returns. Also, any ‘in-the-money’ options will usually vest automatically in the event of a change of control transaction involving the company.

In most cases, securities issued to management will be subject to repurchase rights in favour of the company upon termination of employment. The repurchase price will sometimes vary depending on the circumstances surrounding the employee’s departure.

To effect a direct acquisition of a Canadian target company, a private equity sponsor will almost always incorporate a Canadian acquisition vehicle, which will then acquire the target company by way of an acquisition of the securities or assets. In situations involving a large number of shareholders, either an amalgamation (similar to a US merger) or a court-approved plan of arrangement may be used.

The acquisition method (securities, assets, amalgamation or plan of arrangement) is determined on the basis of various factors, including tax and legacy liability considerations, in addition to the parties’ ability to leverage their positions in the negotiations. Usually, tax and legacy liability considerations will dictate a seller to favour a share sale whereas a purchaser would prefer an asset transaction for the same reasons. However, there are other considerations such as the ability to obtain all assignment consents required in connection with an asset transaction, which can sometimes be challenging in large transactions. We are seeing an increase in the number of hybrid transactions that involve the acquisition of both shares and assets of a target entity, providing tax advantages to both buyer and seller.

Most sell-side transactions are run by way of auctions. An auction process usually takes three months from launch to reach terms with a preferred bidder. Transactions will then generally complete within 30–45 days if no regulatory approvals are required and within 60–90 days if regulatory approvals are required.

In terms of public market transactions, Canadian takeover bids require adequate arrangements (an interpreted statement) to be made, with the effect that a bid cannot be
conditional on financing. Statutory plans of arrangement, on the other hand, can be conditional in nature and allow for more flexibility to provide collateral benefits to managements, etc. Because of this flexibility, most Canadian privatisation transactions involving private equity sponsors are completed by way of a plan of arrangement.

We often see break fees used in connection with ‘no-shop’ conditions and, in public markets M&A transactions, a no-shop provision will be subject to a ‘fiduciary’ qualification.

Canada has two main stock exchanges: (1) the Toronto Stock Exchange (TSX) (senior market); and (2) the TSX Venture Exchange (junior market). In addition to being subject to rules of applicable stock exchanges, Canadian publicly traded companies are also regulated by provincial securities laws, which legislate, among other things, securities offerings, continuous disclosure obligations, insider trading and takeover bids.

Certain of the provinces have additional rules (including approval by a majority of the minority shareholders and independent valuations of the subject matter of the transaction) designed to ensure fair dealing in the treatment of minority shareholders of publicly traded companies in certain types of transactions involving controlling shareholders or ‘related parties’ (which include shareholders owning 10 per cent or more of the voting securities of a corporation). The fair dealing rules also apply to ‘going private’ transactions.

II  LEGAL FRAMEWORK

i  Acquisition of control and minority interests

Private equity sponsors will usually leverage their majority stake in negotiating the governance regime for the acquired entity. If a private equity sponsor has acquired a controlling stake in a Canadian company, it will typically appoint its principals or nominees to oversee the management of the company for the period of the investment. However, it is common to grant minority shareholder rights by way of a unanimous shareholder agreement (as discussed further below) that usually supplement minimum statutory requirements. There may even be a grant of board representation to the minority shareholders. A number of Canadian jurisdictions still require that 25 per cent of the board of directors be comprised of resident Canadians. Often, that requirement can be fulfilled by having a management representative from the minority interest on the board.

Except in certain jurisdictions such as Quebec, where the names of the three largest shareholders are publicly available, the names of the shareholders of a Canadian company are not publicly available. However, the names and residential addresses of directors are available to the public. Notwithstanding the foregoing, private corporations governed by the Canada Business Corporations Act (CBCA) will soon be required to keep a detailed register of information about individuals who, directly or indirectly, have an interest in more than 25 per cent of the shares of the corporation. This would include registered holders and beneficial owners of (1) shares representing 25 per cent or more of a corporation’s voting rights, and (2) any number of shares that is equal to 25 per cent or more of all the corporation’s issued and outstanding shares measured by fair market value, as well as individuals who have direct or indirect control or direction over such shares. The register must contain the name, date of birth, address, residence for tax purposes and other prescribed information for each relevant individual. The CBCA further provides for fines and penalties for non-compliance. That being said, it is important to note that this new register will not be available to the public. However, shareholders and creditors can request access to the register and obtain an extract of it. These CBCA amendments are set to come into force on 13 June 2019.
As referenced above, typically, a unanimous shareholder agreement (USA) will be put in place at the closing of a private equity acquisition to supplement the shareholder rights provided in the relevant corporate legislation and, in the context of an acquisition of control, will ensure that the private equity sponsor controls the Canadian portfolio company, or, in the context of a minority investment, will ensure that the sponsor enjoys minority shareholder rights, including board representation rights and veto rights over material business matters such as acquisition and dispositions, board representation, hiring or dismissal of senior managers, changes to articles of incorporation and by-laws, the issuance of securities and contracting debt.

For a shareholder agreement that sets out veto arrangements to be enforceable against a subsequent shareholder, to fetter the discretion of the directors or to supplant the default provisions of corporate legislation where permitted, the relevant provision must either be incorporated in the articles of incorporation or in a USA (signed by all shareholders). At the director level, only certain director discretion can be fettered by a USA and, most notably, the fiduciary duty directors of Canadian portfolio companies owe to the company cannot be restrained, waived or delegated.

The USA is the typical instrument whereby minority shareholder rights are available to a private equity sponsor taking a minority position in a portfolio company. Usually, in this situation, the USA would ensure that the private equity sponsor has veto power (or at least significant influence) over critical business decisions. Likewise, put and drag-along provisions are key to providing visibility with respect to an exit.

A private equity sponsor will often take a minority interest in the form of a convertible debt instrument. Upon conversion, it would require a USA to be entered into.

Whereas a USA is treated under Canadian law like a constating document (and therefore binding on all current and future shareholders), a shareholder agreement that is not signed by all the shareholders of a company is treated as a regular commercial contract and only binding on the signatories to the agreement.

Where a USA withdraws the powers of directors to manage the business and affairs of the corporation, at least to some extent, shareholders who are given that power inherit the same duties and liabilities imposed on a director under applicable laws.

If a USA or shareholder agreement contains restrictive covenants, it should be noted that Canadian courts will generally not enforce covenants that would prevent an individual from earning a livelihood. What is reasonably necessary depends on the nature of the business, the geographical scope and the duration of the restriction and the functions that the concerned individual used to perform in the Canadian portfolio company.

The following Canadian income tax rules will be relevant to all foreign private equity investors:

**Capital gains on sale of equity interest**

In general, foreign investors are not subject to Canadian tax on capital gains realised on a sale or other disposition of shares of a Canadian company unless the shares have at any time in the 60 months preceding the sale derived their value principally (i.e., more than 50 per cent) from real property situated in Canada. Many of Canada’s income tax treaties, including the Canada–United States Income Tax Convention (the US Treaty), operate to narrow the scope of the above-noted test to the point in time that the subject shares are sold. Certain tax reporting and compliance requirements may apply to the sale.
Withholding tax

Dividend payments made by a Canadian portfolio company to a foreign equity investor are generally subject to a 25 per cent withholding tax while most interest payments between arm's length parties are exempt. Withholding taxes (where applicable) may be reduced by virtue of an income tax treaty. Under most of Canada's income tax treaties, the withholding tax rate on interest otherwise subject to withholding tax is reduced to 10 per cent (a complete exemption is available in most cases under the US Treaty to qualifying recipients). The withholding tax rate on dividends is generally reduced to 15 per cent, subject to a further reduction to 5 per cent or 10 per cent if certain share ownership (or similar thresholds) are satisfied. For example, under the US Treaty, the dividend withholding tax rate is 5 per cent if the eligible US resident shareholder owns at least 10 per cent of the voting stock of the Canadian company.

Management and administration fees

If paid in the normal course of business, management and administration fees paid by a Canadian portfolio company to an arm's-length non-resident for services are not subject to Canadian withholding tax. Otherwise, a 25 per cent withholding tax applies. However, exemptions are available under most of Canada's tax treaties (including the US Treaty) provided the treaty country resident does not render the services through a permanent establishment in Canada.

Thin capitalisation rules

Thin capitalisation rules prohibit Canadian companies from deducting interest on the portion of interest-bearing loans from specified non-residents that exceeds one-and-a-half times the 'tax equity' of the specified non-residents in the Canadian company (generally, unconsolidated retained earnings plus outstanding share capital and contributed surplus attributable to the specified non-residents). For this purpose, a 'specified non-resident' is any non-resident that holds shares representing 25 per cent or more of the votes attached to, or the fair market value of, the outstanding shares of the Canadian company or that does not deal at arm's length with any such shareholder.

Use of foreign intermediaries

It is important to be aware that the base erosion and profit shifting (also known as BEPS) initiative of the Organisation for Economic Co-operation and Development may impact the ability of non-Canadian private equity investors to use favourable intermediary jurisdictions (such as Luxembourg and Netherlands) to channel their investments in Canada. Foreign tax advice should be obtained.

Fiduciary duties and liabilities

In contrast to some American jurisdictions, controlling shareholders in Canada do not owe a fiduciary duty to minority shareholders. However, as in most Commonwealth jurisdictions, the corporate laws in Canada generally provide for an oppression remedy – a statutory remedy available to a complainant where a corporation, a board or a corporation's affiliate acts in a manner oppressive or unfairly prejudicial to, or that unfairly disregards, that complainant's individual interests.
Whether or not designated by a particular shareholder, all directors of the corporation are subject to the same fiduciary duties, which are owed to the corporation (not the shareholder who nominated him or her, as applicable).

The potential liabilities of directors in default of observing their fiduciary duties can be extensive. Directors may be personally liable for breaching the duties of loyalty and of care, or, in other instances, held personally liable for wrongdoing by the corporation. In addition to fiduciary duties, over 100 federal and provincial statutes impose personal liability on directors of Canadian companies, including the corporate legislation governing the Canadian portfolio company, securities laws, environmental laws, employment, labour and pension laws, tax laws and bankruptcy and insolvency laws.

Under applicable Canadian corporate statutes, directors are required to disclose their interest (whether personal or via a related person’s interest) in any proposed material contract or transaction with the corporation. As such, it is intended that all conflicts or potential conflicts of directors as a result of their relationship with the nominating party or other portfolio companies, be disclosed. Subject to limited and narrow exceptions, conflicted directors must refrain from voting on any resolution to approve the contract or transaction giving rise to the conflict.

As a general rule, a Canadian corporation is a distinct legal entity separate from its officers, directors and shareholders. In some limited situations, a court will disregard the separate legal personality and ‘pierce the corporate veil’. This has occurred where the corporation has been completely dominated by a single actor or if the corporation has been used as a shield for fraudulent or improper conduct. Fortunately, Canadian courts have been very reluctant to lift the corporate veil and hold the guiding minds of the corporation liable for the corporation’s actions. There is no single situation or test applied by the Canadian courts for when a court will lift or pierce the corporate veil. There are a number of factors to be considered to determine whether the degree of control is so high that the corporation is a ‘sham, cloak or alter ego’ and those include: where the shareholder intermingles the corporation’s affairs with their own personal affairs; where the corporation is not independent from its shareholders; where the corporation does not have its own assets, skills or employees; and where the corporation does not have its own bank account, books or records.

The use of a partnership or flow-through ownership structure could result in liabilities flowing up to a fund. It would be very unusual to see such a structure without blocker entities being inserted to insulate the fund from liability.

In the case of acquisitions by US private equity funds into Canada, an unlimited liability company (ULC) is often used as the ultimate Canadian company in the acquisition structure. ULCs act as flow-through vehicles for US tax purposes (but not for Canadian tax purposes) allowing US private equity funds to minimise tax at the portfolio entity level in favour of a structure that results in income for tax purposes being realised at the holding level.

III YEAR IN REVIEW

i Recent deal activity

Recently, Canada has seen more evergreen and ultra-long-term funds being formed as opposed to the typically time-constrained private equity fund. More importantly, we have seen increased activities related to co-investments by private equity funds, and to direct investments by Canadian pension funds both locally and abroad.
While the IPO market has remained consistent in 2018, M&A exits continue to be more prevalent (about 90 per cent of the number of exits in the first three quarters of 2018). Secondary sales did, however, represent nearly half of the overall value of the exits.

According to Mergermarket, disruptive sectors such as technology were in the spotlight in Canada in 2018, while activity in historically dominant and more traditional sectors, such as energy mining and utilities, and industrials and chemicals, declined. Overall, 2018 showed a decline in deal value and count, with a total of 596 deals worth a combined US$91.4 billion, compared to 628 deals worth US$97.5 billion in 2017. While the year started on a strong note, Q4 2018 saw a significant decrease in activity, with 135 deals valued at US$12.9 billion, which was down 52.4 per cent from Q4 2017.

### Financing

The most common source of debt financing in a Canadian private equity acquisition remains the traditional senior secured debt obtained from a domestic Canadian bank. However, we see more financing being provided directly by US banks.

Sometimes, a senior facility will be supplemented by mezzanine financing (most of the time provided by way of subordinated debt) provided by banks or other financial institutions. In the past few years, the high-yield bond market has not been very active in Canada in connection with private equity acquisitions. High weighting in energy companies and the lack of liquidity are mentioned as reasons for this slow market.

In many transactions in which we have been involved, the private equity investor provided a bridge loan with respect to a portion of the debt financing required for the acquisition and raised that portion of the debt post-closing.

### Sources of finance

Sources of finance include traditional commercial banks (either individually or in syndicates) and specialised lenders like Antares Capital and NorthLeaf Capital Partners.

### Key financial terms (relative amount of leverage pricing)

While these ranges may vary materially from one industry to another and from one target to another, it would be typical to see debt leverage in this marketplace ranging from 3.5x to 5x EBITDA with a mix of senior debt of 3x to 4x and subordinated debt of 0.5x to 1x. We have seen transactions in which the debt leverage was pushed to 6x EBITDA.

### Key legal terms for financing

Typical legal terms and conditions associated with debt facilities used in connection with a private equity-backed acquisition include:

- **type of facility**;
- **security interest** (usually first lien over the assets in the case of a senior facility);
- **borrowing base and funds available under the facility**;
- **repayment of capital**;
- **interest rate and interest payment**;

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restrictive covenants, including with respect to debt, liens, dividends or acquisitions: the senior facility will provide for detailed covenants whereas any subordinated-debt facility would be expected to be covenant-light; conditions precedent to disbursement; and maturity date.

Comfort letters from the third-party lender or bank are typically tabled as part of a bid to provide comfort with respect to the debt financing.

US private equity investors often have the ability to use US banks to finance their Canadian acquisitions as opposed to using Canadian financial institutions. In these circumstances, hedging strategies and their costs to protect against currency fluctuations become important considerations in the selection of the debt provider.

iii Key terms of recent control transactions

Canadian deal terms are gradually merging with those prevailing in the American market, mainly because of the influence resulting from the increased investment activities of US private equity investors in Canada.

Private equity buyers often require purchase price adjustments to reflect the financial condition of the target. Typically, these are based on a net working capital and debt adjustment. Private equity buyers often seek to negotiate earn out provisions to align a portion of the consideration payable as part of the acquisition to the post-closing financial success of the target company.

Private equity sellers and management teams will limit as much as they can both the scope of the representations and warranties and the duration of their survival period. They will typically push back on the inclusion of full disclosure (10b-5 type) representations and warranties, and will insist on the inclusion of materiality qualifiers and anti-sandbagging provisions.

Private equity sellers generally insist on limiting post-closing exposure as much as possible. They typically limit the length and scope of indemnity provisions as much as possible, as well as other post-closing covenants and undertakings.

Representation and warranty insurance is increasingly utilised as a competitive tool in deal negotiation by private equity firms. Typical carve-outs to these policies include pending litigation, environmental liabilities, future adverse tax rulings, criminal matters, fraud, underfunded benefit plans and bribery and anti-corruption matters. Policies worth up to C$50 million are available from a single insurer.

Usually, private equity investors will seek to have the acquired companies or the shareholders that are related to members of the management provide representations and warranties regarding the acquired companies. However, they usually agree, as sellers, to provide indemnification on a several basis pro rata their entitlement to the sale price and they would seek customary limits to their liability such as baskets and liability caps. Typically, time limits for the exercise of indemnification rights after closing would range between 12 and 24 months, with longer periods for ‘fundamental representations’, and limitations on the amount of liability available for indemnification often vary between 10 and 50 per cent of the sale price. It should be noted that these ranges have been trending down recently. Also, we would generally see a portion of the sale price set aside as a holdback or an escrow as a source of indemnification in case of a breach. If an earn-out is negotiated between the purchaser and the sellers, it would be typical in Canada that the purchase agreement include set-off rights.
between claimable losses and any earn-out payment. That being said, it should be mentioned that the use of representation and warranty insurance in Canada is on the rise and this has a material impact on the foregoing.

Deal certainty is always a consideration, particularly in an auction process. Financing conditions in a transaction worth less than C$100 million would be unusual. A ‘hell-or-high-water’ approach to regulatory conditions is also becoming more prevalent from the sell side perspective.

While still not unusual, reverse break fees are trending up in Canadian private equity transactions. They will usually be contemplated in purchase agreements in a fixed dollar amount. Owing to the increased exposure of the target entity to potential damage from a failed deal, reverse break fees are often higher than the negotiated break fee on a transaction.

iv Exits

There were significantly fewer private equity exits in Canada in 2018. Indeed, as of Q3 2018, the number of exits was less than half the total number of exits in 2017. Almost all exits were by negotiated sales, with only four IPOs.

Two notable exits from 2018 were:

- The C$4.964-billion sale of Husky Injection Molding Systems Ltd by Berkshire Partners LLC and Omers Private Equity Inc to Platinum Equity, LLC, one of the largest reported private equity transactions in the first three quarters of 2018; and
- The C$2.973-billion sale of Atrium Innovations Inc by Permira, Fonds de Solidarité and Caisse de Dépôt et Placement to Nestlé SA.

IV REGULATORY DEVELOPMENTS

There are no other regulatory bodies that have specific oversight over PE transactions or PE sponsors’ activities in Canada, unless the PE sponsor is otherwise regulated, such as in the case of a Canadian pension fund. However, much legislation of general application has an impact on the activities of private equity sponsors in Canada.

i Corporate statutes

In Canada, corporations may be constituted under the federal regime or under the regimes of the various provinces or territories of Canada. While there are differences between these regimes, most of them provide for a fairly similar framework legislating the conduct of business from a corporate standpoint, including amalgamations, the declaration and payment of dividends, the return of capital, directors’ liability, the amendment to the articles of incorporation, the sale of all or substantially all the assets and other material operations outside the ordinary course and provided for in the relevant corporate legislation.

ii Securities regulation

Canadian publicly traded companies are also regulated under provincial securities laws that regulate, among other things, public securities offerings, continuous disclosure requirements, insider trading and tender offer transactions. Certain provinces have additional fair dealing rules designed to ensure the fair treatment of minority shareholders of publicly traded companies in certain types of transactions involving controlling shareholders or related parties.
iii  Foreign ownership
Canada imposes certain restrictions on foreign ownership, including the following.

Investment Canada Act
The acquisition by a non-Canadian of ‘control’ of a Canadian business that exceeds certain prescribed monetary thresholds is reviewable under the Investment Canada Act (ICA) and subject to approval by the federal Minister of Industry or the Minister of Heritage (depending on the nature of the business of the Canadian company). Transactions below the applicable threshold are subject to a notification process. It should be noted that the ICA presumes that the acquisition of one-third or more of the voting shares of a Canadian corporation is an acquisition of control unless it can be established that, on the acquisition, the corporation is not controlled in fact by the acquirer through the ownership of voting shares. In addition, under the ICA, the federal Ministers of Industry and of Public Safety and Emergency Preparedness have the discretionary power to review any investment by a non-Canadian (including investments below the control threshold) where there are reasonable grounds to believe that the investment could be injurious to national security.

Other restrictions
In certain industries, including broadcasting, telecommunications and financial services, Canadian legislation may limit the rights of non-Canadians to own securities of companies involved in these industries. For example, companies subject to the Telecommunications Act (Canada) and having market shares of 10 per cent or more may not be controlled by non-Canadians and their ability to own securities in such companies is limited by law.

Competition Act
A private equity investment that constitutes a merger may also be subject to regulation under the Competition Act (CA). Under this legislation, the term ‘merger’ is broadly defined to include the acquisition or establishment, whether direct or indirect, and whether by purchase of shares or assets, by amalgamation or by combination or otherwise, of ‘control over a significant interest’ in the whole or a part of a business. Pursuant to the CA, parties to mergers that meet certain size thresholds must notify the Canadian Competition Bureau before completing the merger.

V  OUTLOOK
Financial sponsors from China, the Middle East and other emerging markets are increasing their investments in Canada. Sovereign wealth funds, family offices, pension plans, insurance companies and even some mutual funds are allocating money to make private investments and borrowing from the playbooks of the private equity funds. Increased pools of capital chasing a limited number of opportunities combined with a low level of leverage is putting pressure on returns for private equity players. Deal multiples have exceeded the peaks of 2006–2007 in transactions exceeding C$500 million. Many industry players believe that the indicators point to a favourable outlook as long as credit remains readily available and the general partners are able to create value during their hold periods.
Other notable topics

Resident Canadian directors

The corporate statutes of many Canadian jurisdictions, including the federal regime and the province of Ontario, require that at least 25 per cent of the members on a board of directors must be resident Canadian directors. However, jurisdictions such as Quebec, British Columbia, New Brunswick and Nova Scotia have no such requirement.

Distressed M&A

Foreign private equity investors, particularly those interested in opportunities in the distressed M&A market, should also be familiar with Canada's insolvency laws.

Receivership

Receivership can be initiated by creditors privately or via court appointment. A private receivership is initiated when a secured party exercises a contractual right to appoint a receiver pursuant to a security agreement. For secured creditors, a private receivership is usually quicker and less expensive.

Bankruptcy and Insolvency Act

Under the Bankruptcy and Insolvency Act (BIA), creditors may commence bankruptcy proceedings by filing a petition against the debtor corporation, who, among other things, has committed an act of bankruptcy (e.g., failing to meet its liabilities as they become due) in the six months preceding the date of the petition. If the debtor does not oppose the petition, the creditor may obtain a bankruptcy receiving order 10 days after the debtor is served with the petition. Once the receiving order is effective, the assets vest in the trustee of bankruptcy, subject to the rights of the secured creditors. Under the BIA, a debtor has the right to make a proposal to its creditors and each class of creditors will have to vote on the proposal to be accepted (majority in number and two-thirds in value). A secured creditor opposing a proposal will not be bound by the proposal.

Companies' Creditors Arrangement Act

The Companies' Creditors Arrangement Act (CCAA) allows an insolvent corporation with claims against it exceeding C$5 million to make a compromise or arrangement with some or all its secured and unsecured creditors while continuing to operate its business. To become effective, a plan of compromise or arrangement must be approved by each class of creditors by a majority in number and two-thirds in value. After the creditors’ approval, the plan has to be sanctioned by the court. Once sanctioned, the plan is binding on all the creditors included in the plan. The proposal procedure under the BIA and proceedings initiated under the CCAA are primarily debtor-driven and are somewhat analogous to proceedings under Chapter 11 of the US Bankruptcy Code. Generally, the proposal procedures under the BIA are less costly and take less time to complete than proceedings under the CCAA. However, the rules and timelines for BIA proposals are more rigid and the courts have less discretion than the CCAA, which has very few procedural requirements.
I. OVERVIEW

After achieving its best all-around year in 2017, private equity activity in China started to slow down in 2018, signalling the commencement of a new cycle of market development. In 2018, private equity investments in China decreased from the peak of 2017, in terms of both volume of investments and value of investments, but still ranked as the second highest on record by both measures. According to AVCJ Research, the market research division of the Asian Venture Capital Journal, based on its data as at 22 January 2019, there were 1,668 private equity investments (of which 793 were publicly disclosed) with an aggregate investment amount of US$91.75 billion in China in 2018. Compared with 1,823 investments with an aggregate amount invested of US$100.48 billion in 2017, the total volume of investments decreased by 8.5 per cent and the total value of investments decreased by 8.7 per cent in 2018. China was still the most active private equity market in Asia and contributed approximately 50 per cent of the total value of the private equity investments in the Asia-Pacific region in 2018.

The distribution among different investment types in 2018, compared with that in 2017, exhibited a further uptick in expansion and growth-stage investments, and a drop in start-up and early-stage investments, along with a significant 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$74.85 billion or 81.58 per cent of total investment value in 2018, up from US$68.63 billion or 68.30 per cent in 2017; investments in the start-up and early stages represented a smaller proportion of total investment value in 2018 than in 2017, dropping from US$18.11 billion or 18.02 per cent of total investment value in 2017 to US$13.62 billion or 14.84 per cent of total investment value in 2018; and buyouts declined significantly, from US$13.74 billion or 13.67 per cent of total investment value in 2017 to US$3.29 billion or 3.59 per cent of total investment value in 2018.

The significant decline in private equity buyouts in 2018 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 uptick 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 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 going-private activities were almost suspended. Based on statistics obtained through searches on the Thomson Reuters database Thomson ONE, of the 209 going-private transactions announced since 2010, 43 did not proceed (18 of which involved private equity sponsors) and 135 have closed (five closed in 2010, 13 in 2011, 19 in 2012, 18 in 2013, 25 in 2014, 16 in 2015, 24 in 2016, 14 in 2017 and 1 in 2018). As of 31 December 2018, 29 going-private transactions were pending, including three announced in 2012, one announced in 2013, two announced in 2014, five announced in 2015, six announced in 2016, seven announced in 2017 and five announced in 2018. Of the 135 completed going-private transactions, 39 involved private equity sponsors, and of the 29 pending going-private transactions, nine involved private equity sponsors.

In respect of exits via initial public offerings (IPOs), China undertook the longest moratorium on A-share IPOs in its history 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 depended on by China-focused private equity funds, exhibited a further uptick in the second half of 2018, with an 11.4 per cent increase in terms of funds raised in such IPOs and a 109 per cent increase in terms of deal value compared with 2017, according to AVCJ Research. Exits via trade sales and secondary sales, accounting for 77.1 and 5.1 per cent, respectively, of private equity-backed exits in 2017, and 84.6 and 9.8 per cent, respectively, in 2018, according to AVCJ Research, remained the dominant exit route for private equity funds in 2018 and they are likely to maintain this position in the foreseeable future.

In 2018, Chinese outbound M&A deal activity declined from the record-hitting level seen in 2016. This was partially because of heightened scrutiny over these transactions by the United States and certain European 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 AVCJ Research, in 2018, financial investor-backed Chinese outbound investments generally maintained the level of activity seen in 2017 in terms of number of announced deals, with 139 deals announced in 2018 and 134 announced in 2017, while the announced deal value declined by 32 per cent compared with deal value in 2017.
II REGULATORY FRAMEWORK

i 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 (CLSs) and limited liability companies (LLCs). 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, and a foreign-invested company limited by shares (FICLS). FIEs are subject to separate statutes in addition to the Companies Law, including the Law on Wholly Foreign-Owned Enterprises (which applies to WFOEs), the Law on Sino-Foreign Equity Joint Ventures and the Law on Sino-Foreign Cooperative Joint Ventures (which respectively apply to the two types of joint ventures), and the Interim Provisions on the Establishment of Foreign Invested Companies Limited by Shares (which applies to an FICLS), including in each case their respective implementation rules. 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 a Chinese company subject to regulatory approvals. However, through a series of amendments to various company laws in 2016, 2017 and 2018, the regulatory approvals established by the M&A Rules are in practice no longer required, and instead there is a record-filing regime for FIEs in place. This record-filing regime (for certain FIE matters, including incorporation and certain corporate governance changes of FIEs) was established on 8 October 2016 by the central Ministry of Commerce (MOFCOM). On 30 July 2017, MOFCOM promulgated an amendment to further expand the record-filing regime to cover general mergers and acquisitions by foreign investors, 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), pursuant to which the original approval regime under the M&A Rules was, in practice, substantially replaced by the record-filing regime. On 30 June 2018, MOFCOM further amended the record-filing rules to simplify the regulatory procedures applicable to FIEs. Under the new regime stipulated in the 2018 amendment, the filing with MOFCOM will be integrated as part of the regular registration procedure before 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), and after the filing has been submitted, to SAMR only, SAMR will forward the relevant information to MOFCOM for it to complete its filing procedure. The FIEs therefore will enjoy, in general, the same treatment in terms of governmental filing procedures as Chinese domestic companies (except where transactions fall within the scope of the Foreign Investment Negative List). However, to date, this new filing regime has yet to be implemented in practice. There are also other statutes and rules governing transfers of equity, mergers and other transactions involving FIEs.2

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2 These rules include the Certain Provisions on Change of the Equity Interests of the Investors of a Foreign-Invested Enterprise, the Provisions of the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce on Merger and Division of Foreign-Invested
On 19 January 2015, MOFCOM released a draft of the proposed new Foreign Investment Law (the Draft FIL) for public comment. The Draft FIL proposes sweeping reforms to the current Chinese foreign investment legal regime by removing many distinctions between FIEs and Chinese domestic entities and streamlining the oversight of foreign investments, while raising substantial uncertainty as well. If the Draft FIL were to be formally promulgated as it is, without major changes to its terms and provisions, the Law on Wholly Foreign-Owned Enterprises, the Law on Sino-Foreign Equity Joint Ventures and the Law on Sino-Foreign Cooperative Joint Ventures would probably be repealed, while other statutes and rules on foreign investments would require amendments to adapt to the new regime. However, at the time of writing, the Draft FIL has not been submitted to the National People's Congress for a vote. On 26 December 2018, the Standing Committee of the National People's Congress released a high-level summary of the updated draft of the Foreign Investment Law (the Updated Draft FIL) for public comment (from 26 December 2018 to 24 February 2019). The Updated Draft FIL is generally in line with the Draft FIL inasmuch as the proposed Foreign Investment Law would replace the Law on Wholly Foreign-Owned Enterprises, the Law on Sino-Foreign Equity Joint Ventures and the Law on Sino-Foreign Cooperative Joint Ventures. Subject to the discretion of the Standing Committee of the National People's Congress, the Updated Draft FIL may be submitted to the National People's Congress for a vote during its annual meeting in March 2019, and will be further promulgated upon an affirmative approval by the National People's Congress.

Regulatory regimes applicable to foreign investments

An acquisition of or investment in a Chinese company by a non-Chinese investor is subject to a multilayered government approval, filing and registration process. Subject to the recent developments in respect of the record-filing 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), which require the applicable project-based approval of the National Development and Reform Commission (NDRC) or its local counterpart, and the approval by, or filing with, central 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 the 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 the NDRC will grant approval for a 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 by MOFCOM and the NDRC in 2018, 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 industry: industries in which foreign investment is prohibited and industries in which foreign investment is allowed, with certain 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). As there is no mention of the category in the Foreign Investment Negative List, the list of industries encouraged in the 2017 version of the Foreign Investment Catalogue remains effective. 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 investment in an offshore holding company that owns equity of a Chinese FIE is not subject to the 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 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 exceeded 400 million yuan, and either party’s 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. 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), including 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, as from mid 2018, all AML filings are to be made to SAMR instead of MOFCOM. Given this change of regulatory body in relation to antitrust filings, there are as yet no relevant statistics for 2018, from either MOFCOM or SAMR.

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 (FTZs), 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. The Draft FIL has attempted to codify the national security review as part of the foreign investment review regime, and seeks to broaden the scope of review by expressly allowing all types of foreign investments (not limited to acquisitions) to trigger the review and expanding the list of factors that can be taken into account in the review.

Both China’s antitrust and national security review schemes provide Chinese authorities with wide discretion to determine whether a transaction is subject to review or, 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, negative covenants) arguably could 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 unimpeded: 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.

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.

In contrast, the Draft FIL is proposing a shift from the current case-by-case approval regime for all foreign direct investments to a refined regime, namely an ‘entry clearance review’, applicable only to foreign investments in restricted sectors on the Foreign Investment Negative List. However, if the Draft FIL materialises and the concept of ‘de facto control’ is adopted by MOFCOM in determining whether an entity will be treated as an FIE or a Chinese domestic entity and assessing whether certain foreign investors may participate in those sectors on the Foreign Investment Negative List, certain types of indirect investments may unprecedentedly come within the purview of Chinese regulators. Notwithstanding this, given that the Draft FIL has been updated a few times and the Updated Draft FIL is still under review, it is not clear whether this proposal will become reality, or what the details of the applicable rules would be.

Governance of and exit from onshore joint ventures

The Chinese corporate law and regulatory framework applying to FIEs make it difficult for shareholders in a Chinese company to obtain or enforce certain contractual rights that are considered fundamental for private equity investors in other jurisdictions, including rights pertaining to governance and exit. First, members of an onshore equity joint venture have rights of proportional representation on the board, meaning that a Chinese partner typically has the right to appoint at least one director. Further, certain important corporate acts of any joint venture must be unanimously approved by the board, meaning that a Chinese partner typically has the right to appoint at least one director. Further, certain important corporate acts of any joint venture must be unanimously approved by the board, including:

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\begin{align*}
\text{a} & \quad \text{any amendment to the articles of association (which is required in connection with any equity transfer)}; \\
\text{b} & \quad \text{any liquidation or dissolution}; \\
\text{c} & \quad \text{any increase or decrease in registered capital}; \text{ and} \\
\text{d} & \quad \text{any merger or division}.
\end{align*}
\]

As a result, a non-Chinese investor with a majority stake in a joint venture cannot obtain complete control because the minority partner has statutory veto rights via its representative on the board.

Moreover, it may be difficult for a non-Chinese investor to enforce certain exit-related provisions that are often key terms of a private equity investment. Transfers of equity in an onshore joint venture are subject to a statutory consent right and right of first refusal by all other members. Theoretically, these rights can be waived in advance in the joint venture
contract. In practice, however, a transfer of a shareholder’s interest in a Chinese joint venture requires amendments to the joint venture contract and articles of association as well as the filing at both MOFCOM or its local counterpart and SAMR or its local counterpart. Because an amended joint venture contract (which MOFCOM expects to review to approve a transfer) requires signatures from all shareholders, the other shareholders’ cooperation is necessary in connection with any transfer. The same difficulties arise for a private equity investor seeking to enforce a call right, put right or drag-along right against the Chinese shareholders (a tag-along right is easier to enforce, as the party with the tag right can attempt to block a transfer if the transferor fails to comply with the other shareholders’ tag-along right). If the Chinese shareholder is a state-owned enterprise (SOE), enforcement is even more 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 for the foreign investor to invest 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 law 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 letter) of Chinese regulations; however, Chinese companies, including some of the large public companies, such as Alibaba, Baidu and Tencent, continue to use this structure.
There is speculation that the Draft FIL may address and provide explicit rules on the use of the VIE structure. However, as noted above, as the Draft FIL has been updated several times and the Updated Draft FIL is still under review, the details of these rules or whether they will actually materialise remains unclear.

**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. As in many other countries, a breach of duty 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 chair 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 with insurance and indemnification.

*Chinese tax exposure*

Since January 2008, China’s Enterprise Income Tax Law (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 recharacterised 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
China

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 uniform 25 per cent enterprise income tax on its worldwide income where the offshore vehicle’s de facto management body is in China. Although the 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.

SEC enforcement actions

The SEC’s 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 2018, the number of SEC enforcement cases related to the FCPA was the third highest since 2008, with a total of 16 companies paying a record US$2.89 billion to US authorities in settlements. The increase in FCPA enforcement actions from 2017, when only seven settlements were recorded (an all-time low) suggests that FCPA enforcement remains a priority for the SEC. Among the 18 corporate FCPA cases brought by the SEC in 2018, one-third involved conduct related to the actions of Chinese subsidiaries of multinational companies or their activities in China. This included Credit Suisse, which agreed to pay more than US$47 million to settle allegations brought by both the SEC and the US Department of Justice (DOJ) that the bank provided valuable job and internship opportunities to relatives and friends of senior government officials and several Chinese state-owned entities as part of a quid pro quo arrangement for business. The Credit Suisse settlement is the third FCPA

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case against a major financial institution in two years related to the alleged improper hiring of relatives and friends of government officials and state-owned entity employees in China. In 2016, the SEC settled a similar case against JP Morgan Chase & Co for US$130 million.4

The SEC also focused on holding senior management accountable for individual liability in 2018. On 26 January 2018, Michael Cohen, a partner at Och-Ziff Capital Management Group and a member of the firm’s management committee, and Vanja Baros, an analyst, were charged in an SEC civil complaint for violating the FCPA and aiding and abetting Och-Ziff’s violations of the FCPA. These two individual cases brought by the SEC are on top of settlements that the Commission extracted from Och-Ziff and two other executives in 2016. The DOJ was also active in 2018, extracting six guilty pleas from individuals, including one from Julia Wang, a Chinese-born naturalised US citizen, who pleaded guilty to a plot to bribe the former president of the United Nations General Assembly.

**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 (SAIC), the traditional enforcement authority for commercial bribery, into this new agency. It remains to be seen how the new SAMR will ramp up anti-corruption enforcement under the legal regime of the recently amended Anti-Unfair Competition Law (AUCL).

In 2018, the local Administrations for Market Regulation (AMRs) in Shanghai undertook aggressive anti-corruption enforcement actions by imposing 80 administrative penalties on individuals and entities in a variety of industries (e.g., healthcare, technology, manufacturing, construction and logistics), and around 20 per cent of those penalised were multinational companies. Selected high-profile enforcement cases are summarised below.

**a** In July 2018, the Shanghai Qingpu AMR imposed a fine of 150,000 yuan on Lepu Medical Technology (Shanghai) Co, Ltd (Lepu) for unduly influencing doctors at an industry conference by paying speaker fees totalling 32,800 yuan so that these physicians’ presentation materials endorsed Lepu’s products. The Shanghai Qingpu AMR noted in the penalty that the fine was relatively low because the company had no illegal income, and the speaker fee at issue was relatively small.

**b** In October 2018, the Shanghai Jiading AMR imposed a fine of 400,000 yuan on Shanghai Fenner Conveyor Belting Company (part of the Fenner Dunlop group) for providing gifts and cash-equivalent items in the amount of 70,350 yuan to five customers and then recording these expenses as manufacturing and operational costs in its internal system.

There is no evidence indicating that China’s anti-corruption enforcement activities will slow down in 2019. In line with the amended AUCL, SAMR announced in May 2018 that

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China would put more emphasis on enforcements in the pharmaceutical and educational sectors, and any other sectors that may affect people’s livelihood. Local rule-making and enforcement efforts were also stepped up. The Heilongjiang province enacted its local rules on regulating commercial bribery in the healthcare sector in late 2018 and the Zhejiang province investigated 36 cases in a variety of industries in the first half-year of 2018.

Chinese antitrust enforcement update

In addition to dissolving the SAIC, China consolidated the antitrust enforcement functions of two agencies – merger review under MOFCOM and antitrust investigations under the NDRC – into the newly established SAMR. It is expected that China’s antitrust enforcement in the coming year will be more frequent, efficient and consistent.

Although experiencing a transitional period, China’s antitrust enforcement activities continued to be aggressive. According to SAMR’s official announcement, the new agency issued 15 penalty decisions in 2018 out of the 37 investigations initiated. The enforcement cases concerned companies across multiple sectors, including energy, pharmaceuticals, shipping and ports, public facilities and construction materials. High-profile enforcement cases are summarised below.

a  In January 2018, the NDRC penalised two branches of PetroChina Company Limited for a total of 84.06 million yuan for reaching monopolistic agreements with 13 downstream compressed natural gas primary filling stations to restrict the resale minimum price.

b  In November 2018, SAMR stated in a press conference that it had already ‘made significant progress’ in the investigation of Micron, Samsung and Hynix for allegedly exchanging information on a platform called DRAMeXchange to inflate DRAM prices. Subsequent media reports estimated that the penalties could reach US$8 billion.

c  In December 2018, SAMR imposed a penalty totalling 6.25 million yuan on three glacial acetic acid active pharmaceutical ingredient (API) manufacturers, in addition to confiscating illegal gains for their price-fixing monopoly agreements. In December 2018, SAMR imposed a penalty totalling 12.43 million yuan on two chlorpheniramine maleate API manufacturers, as both companies abused their market dominance by refusing to deal with downstream entities without any justification. It has been reported that other investigations by local AMRs in relation to the API sector are also under way.

There is no evidence that Chinese antitrust enforcement will slow down in 2019 as the unified enforcement authority, SAMR, becomes increasingly more sophisticated and equipped to tackle larger and more complex cases. Furthermore, additional antitrust regulatory guidelines on IP, the automotive industry, exemptions and leniency have been approved by the Anti-Monopoly Committee of the State Council, and these new guidelines are expected to be issued and implemented in 2019.

In addition, China is working on improving the procedural posture of its antitrust enforcement process. In December 2018, SAMR promulgated the Interim Provisions Concerning the Procedures for Imposition of Administrative Penalties, which indicates that more detailed provisions on procedures may be drafted in the future.
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 filing or reporting mechanisms.

The 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 the 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’ (to be further clarified by the State Council), 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 the 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 will be abolished from 1 March 2018 following the entry into effect of the new NDRC outbound rules. In addition to Regulation No. 11, the 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, the 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. The 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 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. Also of note is the fact 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.

The NDRC and MOFCOM 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, the NDRC and MOFCOM approvals and filings, and even the 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 the NDRC and MOFCOM 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 the NDRC and MOFCOM 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 the 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 the 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 counterparts, 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 is 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 the NDRC, MOFCOM and SAFE, in their response to a media inquiry on tightened scrutiny over outbound investment transactions, mentioned that they had been
alerts 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:

- Large investments in businesses that are not related to the core businesses of the Chinese investors;
- Outbound investments made by limited partnerships;
- Investments in offshore targets that have assets of a value greater than the Chinese acquirers;
- Projects that have very short investment periods; and
- 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:

- Encouraging investments in overseas high-tech and manufacturing companies and in setting up overseas research and development (R&D) centres;
- Promoting investments in agricultural sectors;
- Regulating investments in oil, mining and energy sectors based on an evaluation of the economic benefits;
- Restricting investments in real estate, hotels, cinemas, the entertainment industry, and soccer clubs; and
- 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 the NDRC.

The tightened control on outbound investment activities and capital flow not only affect Chinese investors, but are 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 outside China, or when a private equity participant is considering a Chinese buyer for a trade sale as its exit route. As mentioned previously, the 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 supply the required funding offshore for the business, which may put stress on various aspects of the operation of the business and may 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). Given that the relationship between the United States and China has deteriorated since the Trump administration took the office, FIRRMA, together with the pilot programmes implemented by CFIUS, is likely to have a dramatic and disproportionate impact on Chinese outbound investments into the United States, especially investments in the highly sensitive areas affected (including sensitive personal data, critical infrastructure, critical technology and, particularly, any state-directed investments) in the near future.

Recent major Chinese outbound investment transactions abandoned or terminated on account of CFIUS issues include:

- 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;
- 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 the CFIUS refusal of approval over national security concerns;
- the termination in November 2017 of US$100 million investment in US financial services firm Cowen Inc by CEFC China Energy Company Limited;
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;

e the abandonment in September 2017 of the US$285 million proposed 10 per cent equity investment in HERE Technologies by a part-Chinese consortium;

f the termination in July 2017 of the US$103 million acquisition of American in-flight entertainment company Global Eagle by the Chinese conglomerate HNA due to parties’ inability to obtain CFIUS approval;

g 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;

h 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 parties’ failure to address national security concerns raised by CFIUS;

i termination in February 2016 of the proposed investment in Western Digital by Unis Union and Unisplendour after CFIUS determined to investigate the transaction; and


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 from 25 per cent to 10 per cent for certain investments in the industries of ‘critical infrastructure’ or ‘military-related products’.

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. Based on statistics obtained through searches on Thomson ONE:

a during 2014, eight US-listed going-private transactions were announced and 18 were closed;

b during 2015, 27 US-listed going-private transactions were announced and six were closed;

c during 2016, 16 US-listed going-private transactions were announced and 15 were closed; and
China

during 2017, six US-listed going-private transactions were announced and five were closed; and
during 2018, 10 US-listed going-private transactions were announced and only one was 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),5 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 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$65.90. 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 Q4 2013 and Q1 2014 but lost more than 80 per cent in value amid continued attacks from Muddy Waters and traded below US$4 for most of 2017, or less than one-fifth of its 2013 high. NQ Mobile Inc was eventually delisted from the New York Stock Exchange (NYSE) on 9 January 2019.

5 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.
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 outsized 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 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 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.

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. Four out of the six US-listed China-based companies that announced receipt of a going-private proposal in 2017 were Cayman Islands companies (and one is a British Virgin Islands company) that accessed the public markets through a conventional IPO, compared with 13 Cayman Islands or British Virgin Islands companies out of 15 US-listed China-based companies in deals announced in 2016, 23 Cayman Islands companies out of 24 US-listed China-based companies in deals announced in 2015, and four Cayman Islands or British Virgin Islands companies out of five significant 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 close (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 follows a comparable timetable for purposes of SEC review.

It is worth noting that 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
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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.
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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, Meilishuo.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, 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 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-ecommerce’ platform, which features a team purchase model, announced the
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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.

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 (COFCO), 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.

ii 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, 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 close, 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 close, 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 (SJEC).

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 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, and 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  Amendment to the Foreign Investment Catalogue

On 28 June 2018, the NDRC and MOFCOM jointly issued the Foreign Investment Negative List, which took effect on 28 July 2018, and repealed in part, on the same date, the previous Foreign Investment Catalogue (revised in 2017). The Foreign Investment Catalogue (including the 2017 and previous versions) categorised industries as encouraged, permitted, restricted or prohibited for foreign investment, while the 2018 Foreign Investment Catalogue lists only those industries subject to special management measures for foreign investment access, including 48 restricted or 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 Foreign Investment Negative List reduces the number of industries restricted and prohibited for foreign investments from 63 (in the 2017 Catalogue) to 48, further loosening restrictions on market access, as well as announcing 22 opening-up measures in various industries, including finance, transportation, professional services, infrastructure, energy, resources and agriculture. Here are the key changes in some of the sectors that were the subject of particular focus:

a  in the financial services sector, the restrictions on foreign shareholding in domestic banks are eliminated, and the cap on foreign shareholding in securities companies, fund management companies, futures companies and life insurance companies is raised to 51 per cent;

b  in the agricultural sector, the restriction on foreign shareholding in the production of seeds of agricultural crops (except the seeds of wheat and corns) is eliminated;

c  in the infrastructural facilities sector, the restriction on foreign shareholding in the construction and operation of freight railway lines and railway passenger transport companies is eliminated;

d  in the transportation and logistics sector, the restriction on foreign shareholding in the design, building and repair of vessels, international marine transportation, and international ship agency is eliminated;

e  in the commercial and trading sector, the restriction on foreign investment in the construction and operation of gas stations, and in wholesale and retail business in rice, wheat and corns is eliminated; and

f  in the cultural sector, the prohibition on foreign investment in internet cafes is eliminated.

The Foreign Investment Negative List also sets out a road map and timetable for 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.

ii  MOFCOM record-filing regime in regulating FIEs

On 3 September 2016, the Standing Committee of the National People’s Congress of the PRC adopted a decision to amend and restate four Chinese FIE laws, 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) and the Law on the Protection of Investment of Taiwan Compatriots. These amendments took effect on 1 October 2016. These amendments replaced the previous MOFCOM approval requirements with a record-filing regime nationwide for all FIEs that are not subject to ‘national market access restrictions’ (which refers to the prohibited and restricted categories in the 2015 Foreign Investment Catalogue as well as any encouraged categories with minimum Chinese shareholding or senior management nationality requirements) in respect of:

a. WFOEs’ establishment, consolidation, divestiture, extension of term and other key corporate changes;

b. EJVs’ joint venture contracts, articles of association, extension of term and early termination;

c. CJVs’ cooperative contracts, articles of association, extension of term, transfer of joint venture interest and designation of third-party management; and

d. establishment of enterprises invested in by Taiwan compatriots.

On 8 October 2016, MOFCOM promulgated the Provisional Measures for Record-filing Administration of the Establishment and Changes of FIEs (MOFCOM Order [2016] No. 3) (the FIE Record-Filing Rules), which took effect on the same date. The FIE Record-Filing Rules set out the procedures of the new record-filing regime to replace the approval regime for applicable foreign investment and FIE matters. The filing regime is applicable to the incorporation of FIEs and filings of FIEs’ corporate changes, except for matters that are subject to national market access restrictions. Filings shall be made through MOFCOM’s online Foreign Investment Integrated Administration Information System.

On 30 July 2017, MOFCOM amended the FIE Record-Filing Rules so that the FIE record-filing regime will apply to general mergers and acquisitions of non-FIE domestic enterprises by foreign investors, as well as to strategic investments in Chinese-listed companies by foreign investors, provided that the investments do not trigger special administration measures and do not involve related-party acquisitions.

On 30 June 2018, MOFCOM further amended the FIE Record-Filing Rules. The new rules took one step further than the previous regulations in streamlining foreign investment regulatory procedures: filings with MOFCOM and SAMR required for establishing or making any material corporate changes to a foreign-invested enterprise will now be made together. Under the new regime, the information required for the MOFCOM filing shall be submitted to SAMR pursuant to the regular registration procedure at SAMR, after which SAMR will forward the information to MOFCOM for it to complete its filing procedure. The applicants therefore no longer have to submit two separate filings with substantially similar information. However, this new filing regime has yet to be implemented in practice.

iii Pilot free trade zones and the Negative List market entry system

On 28 December 2014, the Standing Committee of the National People’s Congress of the PRC promulgated new rules to establish pilot FTZs in Guangdong, Tianjin and Fujian, and to expand the area of the current China (Shanghai) pilot FTZ. The new rules took effect on 1 March 2015. Under the new rules, the current MOFCOM approval requirements for the following matters would become simplified filing requirements in the FTZs:

a. FIE formation;

b. extension of FIE operation terms;
division, merger or other material changes for WFOE;  

dissolution of an equity joint venture (EJV);  

material changes to joint venture contracts and articles of association for a cooperative joint venture (CJV); and  

transfers of interests in a CJV or entrusted management of a CJV.

Thereafter, several new rules have been promulgated to streamline regulatory approval requirements or relax foreign investment restrictions in the FTZs, including the following developments.

On 19 October 2015, the State Council issued the Opinion on the Implementation of the Negative List Market Entry System. The Opinion reflects the Negative List approach that was first applied in China (Shanghai) Pilot Free Trade Zone, and that was later introduced to pilot free trade zones in Guangdong, Fujian and Tianjin.

On 31 March 2017, the State Council released overall plans for launching seven new free trade zones in Chongqing Municipality and the provinces of Henan, Hubei, Liaoning, Shaanxi, Sichuan and Zhejiang. On the same date, the State Council issued the Plan for the Comprehensive Deepening of the Reform and Opening-up of the China (Shanghai) Pilot Free Trade Zone, which lists 25 initiatives for the Shanghai FTZ, including an initiative to reform the company registration regime, such as removing the company name reservation process, optimising domicile and business scope registration and facilitating de-registration. On 24 September 2018, the State Council released the Notice by the State Council of Issuing the Framework Plan for China (Hainan) Pilot Free Trade Zone.

On 30 June 2018, the State Council issued Special Administrative Measures (Negative List) on Foreign Investment Access to the Pilot Free Trade Zone (2018) (the 2018 FTZ Negative List), which is the fifth version of the FTZ Negative List and took effect from 30 July 2018. The 2018 FTZ Negative List, which applies to the 12 pilot FTZs, from Shanghai to Hainan, contains 45 restricted and prohibited sectors, and further opens up certain sectors that are still restricted or prohibited under the Foreign Investment Negative List. The 2018 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 2017 counterpart, the 2018 FTZ Negative List further deleted 50 restrictive measures in several industries. It is expected that the FTZ Negative List will continue to be the benchmark for future amendments of the Foreign Investment Negative List. The 2018 FTZ Negative List is slightly shorter than the Foreign Investment Negative List. In addition to the relaxation of foreign investment restrictions in the Foreign Investment Negative List as outlined above, the 2018 FTZ Negative List further relaxes the foreign investment restrictions in the following sectors as follows:

a. the permitted foreign shareholding in the selection and breeding of new varieties of wheat and corn is increased from 49 per cent to 66 per cent;

b. the joint venture requirement for the exploration and development of oil and natural gas is eliminated, and the prohibition on foreign investment in the exploration, exploitation and ore dressing of radioactive minerals is also eliminated;

c. the foreign shareholding restriction on agencies for shows and performances is eliminated, and the establishment of performing arts groups is now open to foreign investment, but the majority stake should be held by Chinese shareholders; and

d. the pilot policies in respect of value-added telecommunications (e.g., allowing foreign investment in call centre services, domestic multiparty communications services,
internet access services and domestic internet virtual private network services subject to certain foreign shareholding limitations) currently adopted in the original area of the China (Shanghai) pilot FTZ will be introduced to all the other FTZs across the country

iii 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 recently tightened the scrutiny of their authenticity and compliance. 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 NDRC approval and filing with MOFCOM above), 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 where significant government interactions are necessary for their operations, the process can be complex and expensive.

Looking forward into 2019, we expect several key factors to impact the level of dealmaking activities for the year as compared to 2018. One key theme of the region going into 2019 is the extent to which, and in what sectors and geographical regions, China will maintain its economic growth. The intensification of the US–China trade war and the competition between the United States and China in other key commercial areas, combined with an increasingly tightened EU foreign investment-screening framework (which is currently the subject of draft legislation), will also make outbound investment transactions by Chinese investors more challenging. 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. On the other hand, 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. The regulatory landscape is also a key factor that may impact investment patterns. With a number of important legal and regulatory developments affecting businesses in mainland China having been launched in 2018, the implementation of these legal and regulatory changes may bring in significant changes, not only in how business models are selected, but also in how they will evolve. For certain industries or sectors where 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 where 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 both the United States and Hong Kong in 2018, 2019 is expected to be another strong year for IPO exits in overseas stock markets, but continued difficulties for companies seeking to list in the domestic A-share listings may present challenges for companies looking to be listed domestically. While the Chinese domestic securities market has endeavoured to provide more flexible channels for companies to list on the A-share market (including the launch of a ‘registration-based IPO system’ to be piloted by the Technology Innovation Board of the Shanghai Stock Exchange) the effects of this pilot programme remain to be assessed. Offshore banks and credit funds could regain their main role in financing M&A activities in the region in general, given the decreased lending capacity of Chinese banks with respect to offshore transactions and 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 2019 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, where 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

COLOMBIA

Hernando A Padilla and Pedro Arango

I OVERVIEW

As at June 2018,² a total number of 125 private equity funds (PEFs) had been incorporated in Colombia,³ 25 of which were at the fundraising stage and 14 of which were at the liquidation stage. As at June 2018, a total of US$16.57 billion had been raised in capital commitments to invest in Latin America, in comparison to a total of US$14.72 billion raised as at June 2017⁴ and US$924 million raised by the total number of PEFs in place prior to 2010.⁵

Of the 111 active PEFs, 37 are buyout funds (33.3 per cent), 29 are real estate funds (26.1 per cent), 19 are infrastructure funds (17.1 per cent), 14 are venture capital funds (16.6 per cent), nine are environmental and social impact initiatives funds (8.5 per cent) and three are natural resources funds (2.8 per cent).⁶

Deal activity

From 2005 to June 2018, PEFs carried out 701 investment transactions, compared with a total of 607 investment transactions as at June 2017. The preferred industries for investments have been mining and energy (US$4.13 billion), real estate (US$2.94 billion) and infrastructure (US$662.1 million). Other sectors in which PEFs have invested are oil and gas, services, health, retail, financial services, manufacturing, transportation and logistics, agroindustry and information technology (IT). The amounts invested during this period were equal to US$10.75 billion.⁷

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1 Hernando A Padilla is a partner and Pedro Arango is an associate at Philippi Prietocarrizosa Ferrero DU & Uría.
2 This chapter aims to include the most up-to-date information available at the time of writing. Note, however, that certain information is only available up to a cut-off date of 31 December 2017 (information included in the report of the Association for Private Capital Investment in Latin America (LAVCA) – ‘2018 LAVCA Industry Data & Analysis’; see footnote 9) or 30 June 2018 (EY–Colcapital 2018 report; see footnote 3).
4 Ibid., p. 56.
7 Ibid., pp. 65–66.
The following table shows the number of transactions carried-out by each type of PEF and the invested amounts:

<table>
<thead>
<tr>
<th>Type of fund</th>
<th>Number of transactions</th>
<th>Invested amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td>44</td>
<td>US$5.55 billion</td>
</tr>
<tr>
<td>Real estate</td>
<td>429</td>
<td>US$3.11 billion</td>
</tr>
<tr>
<td>Buyout</td>
<td>78</td>
<td>US$1.66 billion</td>
</tr>
<tr>
<td>Natural resources</td>
<td>57</td>
<td>US$361.2 million</td>
</tr>
<tr>
<td>Environmental and social impact initiatives</td>
<td>18</td>
<td>US$36 million</td>
</tr>
<tr>
<td>Venture capital</td>
<td>75</td>
<td>US$32 million</td>
</tr>
</tbody>
</table>

In 2018, Colombia was ranked by the Association for Private Capital Investment in Latin America (LAVCA) as the third most dynamic Latin American private equity/venture capital (PE/VC) market in terms of number of deals, surpassed only by Brazil and Mexico, reporting 41 investment transactions that took place in 2017, in comparison to the 22 transactions registered in 2015. In total, US$772 million were invested in those 41 transactions, which represents a US$324 million increase compared to the US$448 million invested in 2016.9

As regards recent trends in PE transactions, infrastructure projects continued to be one of the main growing focuses of PE investments in 2018. In this respect, the Canadian PEF Caisse de dépôt et placement du Québec (CDPQ) and the governmental financial entity Financiera de Desarrollo Nacional (FDN) announced the launch of a fund that will invest approximately US$ 1 billion in infrastructure projects, of which approximately US$500 million will be invested by CDPQ.

Additionally, BlackRock, Ashmore and UPLI participated in the financing of the 4G toll road projects Transversal del Sisga and Ruta del Cacao. In the Transversal del Sisga project, BlackRock and Ashmore Group acted as senior lenders, and for Ruta del Cacao, BlackRock and UPLI acted as senior lenders on the project, while Ashmore was one of the sponsors and shareholders of the concessionaire developing the project.

Other trends show substantial growth in recent years in the IT sector, which historically had not been so significant. However, in 2016 and 2017, the IT sector had the largest number of closed deals (nine of the 22 deals in 2016, and 17 of the 41 deals that took place in 2017). Furthermore, in 2017, US$183 million (41.5 per cent of the total invested by PEFs) was invested in IT, compared with US$160 million invested in 2016 and US$1 million in 2015.10

Also of note was that 13 of the 41 deals closed in 2017 were related to early-stage assets, while US$423 million was invested in assets at a growing finance stage.11

Finally, four exits occurred in 2017 in comparison to the six exits reported in 2016.12

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8 Ibid., p. 65.
10 Ibid., p. 25.
11 Ibid., p. 24.
Operation of the market

While secondary buyouts and trade sales have been identified as the most important exit routes for PE/VC investments in Latin America, there is no standard sales process for PE divestitures in Colombia, and the overall duration of buyouts and trade sales will depend to a large extent on, *inter alia*, transaction complexity, number of intervening parties, regulatory approvals and financing schemes (if applicable).

Management equity incentive arrangements, on the other hand, will depend on the specific provisions in private placement memoranda governing remuneration of general partners (GPs), and on the terms and conditions of engagement of the GPs with the relevant funds. Therefore, a correlation between carried interest arrangements and duration of trade sales and buyouts is hard to establish.

II LEGAL FRAMEWORK

Under Colombian law, PEFs are a special type of collective investment fund (CIF) governed by Decree 2555 of 2010 (Decree 2555). CIFs are defined as collective investment vehicles funded by capital or other in-kind contributions made by limited partners (LPs). Funds raised through a CIF are managed and invested in accordance with the investment objectives and policies set out in the CIF’s private placement memorandum. Participation units and voting rights are allocated to LPs on the basis of their individual contributions to the CIF.

PEFs, in turn, are CIFs in which at least two-thirds of LPs’ capital commitments are invested in equity or debt securities other than those registered in the National Registry of Securities and Issuers. An LP’s capital commitment in a PEF must equal at least 600 minimum monthly wages under Colombian law for the LP to acquire participation units and voting rights in the fund. In addition, PEFs have a fixed-term focus that requires LPs to commit their funds for a minimum period.

All CIFs, including PEFs, must be administered by qualified institutions under the supervision of the Colombian Superintendence of Finance (SFC). Trust companies, broker-dealers and investment management companies are the only types of regulated institutions authorised to administer PEFs in accordance with the provisions of Decree 2555. These institutions, referred to collectively as PEF administrators, perform PEFs’ back-office duties. Among other duties, PEF administrators must:

- deliver portfolio securities to the designated custodians, if applicable, and provide those custodians with all information required for the adequate performance of their custodial duties;
- perform periodic portfolio valuations in addition to the periodic valuation of PEFs’ participation units;
- keep separate accounting records for each PEF under their administration;
- comply with certain reporting duties before LPs and local regulators (namely the SFC and the Colombian self-regulatory organisation of the securities market, the AMV);

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14 However, a PEF’s private placement memorandum may also set out special terms and conditions governing early or partial redemption of LPs’ participation units.
15 These institutions are also referred to collectively as CIF administrators in the event that the relevant CIF is not a PEF.
e design, approve and execute corporate governance policies required in connection with PEF administration duties;

f exercise all voting rights attached to the portfolio securities under their administration; and

g appoint portfolio managers, as applicable.

Generally, a CIF’s portfolio management and investment advisory duties may be performed directly by the CIF administrator, or may otherwise be performed by an external or foreign portfolio manager appointed by the CIF administrator. As with CIF administrators, only trust companies, broker-dealers, and investment management companies under SFC supervision may be appointed as CIF external portfolio managers.

The appointment of an external or foreign portfolio manager does not release the CIF administrator from its liability in relation to LPs. On the contrary, the CIF administrator will be liable to the SFC and the fund’s LPs for the selection and appointment of an external or foreign portfolio manager. The CIF administrator’s liability will be at stake in the event of slight negligence in the performance of its functions.

In addition to an external or foreign portfolio manager, the CIF administrator (or the external or foreign portfolio manager, as the case may be), must appoint an individual to act as the CIF’s general manager. In the case of PEFs, however, appointment of a general manager will not be required in the event that a GP has already been appointed. Selection criteria for the appointment of a general manager or GP must be included in the fund’s private placement memorandum.

Unlike CIF external portfolio managers, GPs do not have to be regulated institutions under SFC supervision. This regulatory distinction between GPs and external portfolio managers is justified by the nature of PEFs’ investments (as at least two-thirds of the funds are invested in unregistered securities). The unregulated nature of a GP is further offset by the appointment of a PEF supervisory committee in charge of overseeing the GP’s performance of its duties and ensuring compliance with applicable laws and regulations.

The general manager or the GP, as applicable, will be in charge of performing the fund’s portfolio management duties on behalf of the PEF administrator. Portfolio management duties include deciding on the fund’s investments and divestitures in addition to identifying, measuring, controlling and managing all risks associated with the fund’s portfolio investments. In performing its portfolio management functions, the GP will be supported by the fund’s investment committee, which will be responsible for the analysis of investment and divestiture decisions, the definition of investment caps, and the implementation of policies governing the acquisition and liquidation of portfolio investments. While PEF administrators will remain liable up to slight negligence for the appointment and supervision of GPs, the latter will bear full responsibility for the relevant funds’ investment decisions.

Finally, under Colombian law, GPs may also acquire participation units in a PEF under the terms and conditions set out in the fund’s private placement memorandum.

i Acquisition of control and minority interests

A PEF’s controlling investment in a portfolio company is subject to the laws and regulations governing the acquisition of control and majority shareholders’ rights and obligations. A number of private placement memoranda state that the GP will aim for all or most of its
portfolio investments to grant the fund a controlling stake (whether directly or indirectly) in the relevant portfolio companies without fully excluding the possibility of acquiring minority interests.

Law 222 of 1995 (Law 222) provides that a company will be considered to be under the control of a majority shareholder if that company’s decision-making power is subject, directly or indirectly, to the will of one or more third parties considered to be controlling entities. While not precisely intended to include PEFs or CIFs in general, the provisions of Law 222 are currently deemed to be binding, mutatis mutandi, upon corporations and CIFs (including PEFs), regardless of the latter’s non-corporate nature.

As such, a portfolio company will be under a PEF’s controlling investment in the event that:

a) 50 per cent or more of the portfolio company’s issued and outstanding capital stock is held by the relevant PEF, whether directly or indirectly;

b) the relevant PEF has the right to issue the number of votes required to reach a minimum voting majority in the company’s shareholders’ meeting or equivalent corporate body, or the requisite number of votes to appoint the majority of the company’s board of directors; or

c) the relevant PEF exercises a prevailing influence over the decisions taken by the portfolio company’s corporate bodies.

Controlling shareholders have two main obligations with respect to corporate law matters: they must register their control situation before the mercantile registry kept by the competent chamber of commerce in the controlled company’s corporate domicile;16 and they must prepare consolidated financial statements to report the financial situation, results of operations, and changes in equity and cash flows of the controlling entity and the controlled company as if they were a single entity.

Should a GP hold a controlling stake in a portfolio company, it must further comply with the relevant provisions of the company’s by-laws in the event it intends to conclude a full or partial exit of its portfolio investment. Among other things, rights of first refusal in the negotiation and transfer of shares and rights of withdrawal, in addition to drag-along and tag-along provisions are common, and in many cases are standard clauses in by-laws and shareholders’ agreements. If, on the contrary, a PEF holds a minority interest in one of its portfolio companies, the foregoing provisions will afford additional protection to minority shareholders.

Other limitations imposed upon controlling shareholders include the existence of super-majorities provided for by law, as in the case of stock corporations,17 or otherwise set out in a portfolio company’s by-laws.

Finally, in the event that the fund’s GP is domiciled abroad, a special power of attorney must be granted in favour of a third party to act on behalf of the GP in Colombia for all legal purposes. Should a foreign GP acquire participation units in the PEF for which it has been

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16 The PEF, and not the PEF administrator or the GP, will appear in the portfolio company’s mercantile registry as the company’s controlling shareholder, as stipulated by the SFC in Concepto 2012101056-001 dated 14 January 2013.

17 These super-majorities are required in, inter alia, stock corporations, to decide on the distribution of profits below the minimum percentage required by law, to waive pre-emptive rights in the issuance of new shares and to pay dividends in kind.
appointed portfolio manager, the GP must register its foreign portfolio investment with the Colombian Central Bank by completing and filing foreign exchange forms to be submitted to foreign exchange intermediaries (local banks) in the PEF’s jurisdiction of incorporation. A similar procedure must be followed upon redemption of the GP’s participation units in the relevant PEF.

ii Fiduciary duties and liabilities

A GP’s representatives on a portfolio company’s board of directors will be deemed to be managers under Law 222. The GP’s representatives owe several fiduciary duties to the portfolio company and its shareholders.

Under Law 222, company managers, including board of directors’ members, shall at all times act in good faith and seek to benefit the company’s interests and the interests of its shareholders, their standard of diligence being that required from a good businessperson.

In performing their duties, company managers and directors must:

a direct all their endeavours to the adequate fulfilment of the company’s corporate purpose;
b aim for strict compliance with all relevant legal provisions in addition to the provisions of the company’s by-laws;
c ensure adequate performance of the statutory auditor’s duties;
d preserve and protect the company’s trade secrets and other confidential information;
e refrain from misusing privileged information;
f afford equitable treatment to all company shareholders and respect the exercise of the shareholders’ inspection rights; and

g refrain from participating, whether directly or indirectly, and with the purpose of fulfilling a personal or third-party interest, in any competing business activity or in any other activity that may give rise to a conflict of interests, unless specifically authorised by the company’s shareholders’ meeting or corporate body competent for that purpose.

Law 222 further provides that company managers and directors will be jointly and severally liable before the company, its shareholders and third parties for any damage caused as a result of their negligence or wilful misconduct. Company managers and directors who are unaware of the acts or omissions giving rise to such damage, or who otherwise voted against the approval of the relevant acts or decisions and did not later execute them, will not be subject to the foregoing liability standard.

Conversely, directors’ and managers’ negligence will be presumed in the event of abuse of office or any other breach of managers’ and directors’ duties, or in the event of a breach of the company’s by-laws or applicable laws and regulations.

In the event that an individual director’s liability is compromised, the company may file a corporate responsibility suit, provided that the filing has been previously approved by the company’s shareholders’ meeting with a simple voting majority. A successful corporate responsibility suit will entail removal of the corresponding director. If, however, the company does not proceed with the corporate responsibility suit within three months of approval of the filing by the shareholders’ meeting, the company’s statutory auditor or any other company director may enforce the claim.

18 The relevant provisions of Law 222 regarding directors’ liability and other corporate matters have been incorporated into the Colombian Commercial Code.
Similarly, the company’s creditors may also exercise the corporate responsibility suit against directors, provided, however, that the creditors represent at least 50 per cent of the company’s external liabilities and that the company’s equity is insufficient to pay for all the company’s outstanding obligations. Filing of a corporate responsibility suit does not preclude enforcement of individual rights held by the company’s shareholders and other affected third parties against defaulting directors.

Finally, domestic industry standards and current market practice evidence contractual limitations to both GPs’ liability and the liability of GP-appointed directors in portfolio companies by way of comprehensive insurance policies paid for by PEFs. Insured risks include, *inter alia*, third-party damage caused by GPs in performing their portfolio management functions (including damage caused to PEF administrators and LPs); third-party damage caused by GP-appointed managers and directors in portfolio companies (including damage caused to the relevant portfolio companies, their shareholders, creditors, or other portfolio company managers); and labour practices and labour-related damage inflicted upon third parties by GPs or GP-appointed managers and directors.

### III YEAR IN REVIEW

#### i Recent deal activity

In addition to the general considerations and specific deals described above (see Section I), it is worth mentioning that buyouts and growth financing remain the most popular PE/VC investment strategies in Latin America.19 Colombia’s recent deal activity is a clear example of this. Thus, of the 41 deals occurring in 2017, 11 were buyouts and 12 were growth financing. Furthermore, of the US$772 million invested in 2017, US$253 million was invested through buyouts and US$423 million through growth financing.20

#### ii Financing

Pension funds are the most important investors in Colombian PE/VC funds, followed by other financial institutions. As at June 2018, 41.5 per cent of PE/VC investors were pension funds, while 20.6 per cent were corporate investors. Insurance companies and banks held 5.9 per cent and 5.1 per cent respectively of PE/VC equity interests and the remaining 23 per cent was held by other investors, such as high-net-worth individuals (4.9 per cent), family offices (4.6 per cent), multilateral institutions (4.2 per cent), funds of funds (4 per cent), multi-family offices (3 per cent), sovereign funds (2.6 per cent) and endowments (2.3 per cent).21

During the period January 2005 to June 2017, 66.5 per cent of the investors were local investors while 33.5 per cent were foreign investors. These figures, compared with those of 2014 (81 per cent local investors compared with 19 per cent foreign investors) and those of 2016 (72.4 per cent local investors compared with 27.6 per cent foreign investors) show an increase of foreign investors’ stake in Colombian PE/CV funds.22

The most common financing schemes for PE/VC transactions include leveraged buyouts and syndicated loans.

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19 See footnote 9, p. 22.
20 Ibid., p. 24.
21 See footnote 3, p. 50.
22 Ibid., p. 51.
One of the most recent examples was the syndicated financing granted by Sumitomo Mitsui Banking Corporation, Export Development Canada, Scotiabank and Itau CorpBanca Colombia to the Canadian PEF Brookfield Infrastructure Partners LP for the acquisition of a controlling stake in Gas Natural’s Colombian interests for a purchase price of approximately US$590 million.

Other notable examples include Darby Private Equity’s acquisition of a minority stake in and transportation rights from Ocensa, which was made possible by way of a credit agreement with Itaú Unibanco Nassau Branch. Collateral over the purchaser’s shares was granted in favour of Itaú Unibanco and escrow accounts were established to further guarantee debt repayment. A syndicated loan was also granted by Itaú Unibanco Nassau Branch and Banco Davivienda in favour of Terranum to finance its acquisition of Decameron Hotels & Resorts. A syndicated loan was granted in favour of Altra Investments, Mercantil Colpatria and SCL Energía Activa to finance their joint acquisition of Termovalle SA ESP, and a syndicated loan was granted by Bancolombia, Bank of Tokyo and Banco Santander to finance Colombian electricity generator Celsia SA ESP’s acquisition of several power plants in Costa Rica and Panama.

Legal restrictions to be considered in structuring financings of PE transactions include the prohibition on entities under SFC supervision financing the acquisition of a controlling stake in a portfolio company with funds received from the general public (clients), and the prohibition on commercial banks facilitating loans aimed at acquiring a majority interest in an entity that falls under SFC supervision.

iii Key terms of recent control transactions

Canadian PEF Brookfield Infrastructure Partners LP acquired 53.11 per cent of the equity interest in Gas Natural in Colombia for a purchase price of approximately US$590 million. The transaction was undertaken in two stages: in December 2017, the fund acquired from the Spanish firm Gas Natural Fenosa 11.22 per cent of the shares in Gas Natural in Colombia; the remaining 41.89 per cent of the shares were acquired through a public offering on the Colombian stock exchange.

In January 2018, MAS Equity Partners, through its vehicle MAS Equity Fund III, and Rocsa Colombia SA acquired 100 per cent of the shares of the Colombian chemical distributor Inproquim.

In August 2018, DST Global led investment of US$200 million in Colombian start-up Rappi. Rappi is an on-demand delivery company operating in Colombia, Argentina, Brazil, Chile, Mexico and Uruguay. In 2018, it joined the ‘unicorn’ club by being valued at US$1 billion; other PE/VC funds, such as Sequoia Capital and Andreessen Horowitz have invested in the company.

In December 2018, the British fund Alpha Blue Ocean acquired from Colombian fund Tribeca Partners 100 per cent of the equity interest of the Colombian company Onda de Mar; Australis Partners acquired from Advent International and Organización DeLima 50 per cent of the equity interest in Alianza Fiduciaria (one of the largest trust companies in Colombia); and the PEF Aqua issued a letter of intent with the controlling shareholders of the Colombian financial entity Financiera Dann Regional, pursuant to which the fund will become the controlling shareholder of the company following certain investments in the company to be undertaken within the next two years.
Exits

Colombia reported the second-largest amounts generated by exits in Latin America during 2017 (US$309 million through four exits), surpassed only by Brazil (with US$2.5 billion through 27 transactions). Nonetheless, both in number of exits and the amounts these generated, Colombia saw a substantial decrease compared with the 2016 figures (US$1 billion through six exits). Nonetheless, during the first half-year of 2018, nine exits were reported, showing a significant increase in comparison with 2017 and 2016.

Recent notable exits in 2017 and 2018 include the following. In April 2017, Nexus Capital Partners divested its investment in Airplan SA and Aeropuertos de Oriente SAS in a deal that saw Grupo Aeroportuario del Sureste acquire 92.42 per cent of the equity interest in Airplan SA and 97.26 per cent of the equity interest in Aeropuertos de Oriente SAS for a total amount of US$262 million.

In May 2017, Rural Impulse Funds I and II (vehicles of Belgium’s Incofin Investment Management) sold 55.2 per cent of the equity interest in Crezcamos SA.

In January 2018, the PEF Valorem sold to DHL Supply Chain 100 per cent of the equity in the Colombian logistic services supplier Suppla group. The purchase price was within the range of US$50 million to US$60 million.

In April 2018, the Colombian PEF Altra Investments agreed the transfer of Colombian packaging company Proenfar to Weener Plastics Group.

In September 2018, the PEF Fondo de Capital Privado MAS Colombia LatAm transferred to the Peruvian group Auna (through its Colombian vehicle) 97 per cent of the equity interest in the company Promotora Médica las Américas for a purchase price of approximately US$140 million.

As noted above, in December 2018, Tribeca Partners and Advent International divested their participation in Onda de Mar and Alianza Fiduciaria respectively, while in January 2019, The Indian company Taghleef acquired from the fund Valorem and from Lisa Holdings 100 per cent of the equity interest in the Colombian company Biofilm (a biaxially oriented polypropylene manufacturer).

IV REGULATORY DEVELOPMENTS

In terms of regulatory oversight, PEF administrators are permanently subject to supervision by the SFC. As such, PEF administrators must comply with all applicable laws and regulations governing their permitted activities (which will in turn depend on their specific legal nature under the Organic Statute of the Financial System), and further comply with their PEF administration duties in the terms set out under Decree 2555 and other complementary regulations.

Fund formation is also subject to special controls by the SFC. While a prior authorisation is not strictly required, all PEFs must be registered with the SFC. To register, the PEF administrator must file the PEF’s private placement memorandum and other supporting documents with the SFC. As of this filing, the private equity fund is entitled to start operations. Nonetheless, the SFC may subsequently provide its comments or objections to the private placement memorandum, if any, in due course. In the absence of

23 See footnote 9, p. 9.
24 See footnote 3, p. 69.
any comments or objections from the SFC, or following their incorporation or reply in the private placement memorandum, the SFC will issue a resolution assigning a specific code (or ID) to the relevant fund. Following the issue of this resolution, the fund will be ready to start its operations, which will at all times be subject to the provisions of the fund’s private placement memorandum.

PE transactions and GPs’ activities are subject to several internal corporate governance controls, such as the oversight functions performed by the PEF administrator and the PEF’s surveillance committee over a fund’s GP. In addition, PE transactions (both portfolio investments and divestitures) are to a large extent subject to the analyses of investment and divestiture decisions carried out, and the recommendations issued by, a fund’s investment committee.

On the other hand, the most recent regulatory developments relating to PEFs have been undertaken by the Financial Regulation Unit (URF), a special dependency of the Colombian Ministry of Finance and Public Credit (MHCP), since its inception in 2013. Other private initiatives, such as the creation of the Colombian PEF Trade Association (Colcapital), further contribute to an effective interplay between relevant market players and local regulators in the design and approval of new regulations governing the fundraising, administration, corporate governance and investment regime of PEFs.

A non-exhaustive list of both recent regulatory developments and draft regulations currently under discussion includes:

a Decree 765 of 2016, whereby the MHCP modified pension funds’ investment regime to:
   - reorganise admissible assets in accordance with a risk-based approach, allowing segregation of traditional assets and alternative assets;
   - introduce a new category of assets – ‘restricted assets’ – aimed at contributing towards the diversification of risks associated with pension funds; and
   - modify investment caps and requirements for currently admissible assets, especially for investment vehicles incorporated by foreign issuers;

b Decree 2103 of 2016, whereby the MHCP modified the insurance company investment regime to:
   - include local and foreign real estate PEFs as eligible assets in which those entities may invest;
   - replicate the constraints and restrictions applicable to pension funds with respect to investments in PEFs whose main assets are infrastructure projects; and
   - modify the maximum percentage that insurance companies can allocate in PEFs;

c External Circular Letter 15 of 2016, whereby the SFC modified the rules applicable to the valuation of PEFs’ assets;

d External Circular Letter 35 of 2016, whereby the SFC gave instructions regarding the ownership structure reports that the PEFs must deliver to that entity;

e External Circular Letter 54 of 2016, whereby the SFC added certain rules regarding factoring operations and trading of economic rights and securities not listed in the stock exchange;

f Decree 1756 of 2017, whereby the MHCP set out certain rules applicable to investments made by Colombian investors in foreign investment vehicles (including PE/VC funds);

g External Circular Letter 37 of 2017, whereby the SFC modified the rules applicable to the valuation of a PEF’s portfolio;
Decree 1984 of 2018, whereby the MHCP made a complete and comprehensive amendment of the PEF regime by removing the existing cross-references to the CIF regime (with many of the rules applicable to CIFs being expressly included in the PEF regime), and by introducing certain new rules applicable to PEFs, such as:

• express authorisation for PEFs to carry out certain operations, such as the issuance of bonds in the stock exchange and the granting of financings; and

• a requirement for the valuation of the PEF’s portfolio to be made by the GP (previously a duty of the PEF’s administrator); and

Law 1943 of 2018 (effective from 1 January 2019), pursuant to which certain tax reforms were introduced.

Of the reforms introduced by Law 1943 of 2018, the most relevant for the private equity market is the amendment of the tax deferral regime applicable to private equity funds income. Under the former regime, all fund earnings were subject to a tax deferral since tax was levied at the moment those earnings were distributed to the LPs. Under the new regime, this tax deferral applies only with respect to (1) funds listed on the stock exchange; or (2) funds that do not have a person owning, directly or indirectly, more than 50 per cent of the fund’s equity interest or a beneficial owner or LP with control at this level of interest to approve the distribution of earnings. To qualify for the tax deferral regime, PEFs set up prior to 31 December 2018 must comply with these requirements by June 2020.

V OUTLOOK

While the investment landscape in Colombia remains dynamic, a comprehensive look ahead at PE and VC deals and regulatory developments must weigh up the following considerations.

It is expected that the vast majority of Latin American LPs will have PE infrastructure investments in the continent within the next couple of years. Considering the government’s continuing initiatives to raise and allocate resources, such as the initiative to open a PEF to support the development of 4G infrastructure projects, Colombia is no exception to this regional trend.

Although, in the wake of the 2008 global financial crisis, approximately one-third of LPs have invested in the Latin American-focused debut funds of new GPs, the scarcity of established GPs is still seen as the biggest deterrent to new investors in Latin America. In the case of Colombia, the number of new GPs created in 2017 (four) and in the first half-year of 2018 (one) is lower than the number of GPs created each year since 2007. Perceptions about exit barriers, regulatory burdens, currency fluctuations and constant tax reforms may further jeopardise LPs’ willingness to invest in Colombia-based PEFs.

In spite of the foregoing, the stronger interplay between policymakers (such as the URF and the SFC), industry practitioners and trade associations (Colcapital) has favoured the ongoing revision and improvement of existing regulations governing PEFs and PE transactions. A special focus on reforms to pension fund investment regimes with a view

25 See footnote 13, p. 9.
26 Ibid., p. 9.
27 Ibid., p. 4.
28 See footnote 3, p. 38.
29 See footnote 13, p. 12.
to adapting to international practices and industry standards is particularly noteworthy in this regard. Successful regulatory developments in this area may significantly enhance fundraising strategies.

Finally, in recent years, the number of foreign GPs (in comparison to local ones) has increased. Thus, while in June 2017 only 49.2 per cent of GPs were foreign, by June 2018, this figure was 53.8 per cent.30

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30 See footnote 3, p. 44.
Chapter 6

GERMANY

Volker Land, Holger Ebersberger and Robert Korndörfer

I

OVERVIEW

Deal activity

In 2018, the German private equity (PE) market continued to be very active in the first half-year but slowed down in the second. Looking at the aggregated numbers, the deal activity (buyouts and exits) remained on a high level both in terms of volume and number. With a total buyout volume of €17.9 billion, it did not reach the level of 2016. The number of buyouts did, however, increase slightly compared to the total for 2016. Four PE-backed initial public offerings (IPOs) took place in 2018.

<table>
<thead>
<tr>
<th></th>
<th>2018 total</th>
<th>Half-year 1 (HY1) 2018</th>
<th>HY2 2018</th>
<th>Changes between HY1 and HY2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total buyouts</td>
<td>17.9</td>
<td>11</td>
<td>6.9</td>
<td>-37.27%</td>
</tr>
<tr>
<td>(billions of euros)*</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total exits†</td>
<td>10</td>
<td>8.6</td>
<td>1.4</td>
<td>-83.72%</td>
</tr>
<tr>
<td>(billions of euros)‡</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* See footnote 3; † Excluding IPOs; ‡ See footnote 3.

Large-cap companies are of particular interest especially for non-German PE investors. In 2018, five PE transactions exceeded the €1 billion threshold. The increase of the total number of PE deals in relation to a slight decrease of the volumes compared to 2016 shows that small and mid cap companies continue to constitute the predominant part of the deal activity of PE investors in Germany.

All in all, the volumes of PE transactions remain at a high level in Germany but show for the second year in a row a slight decrease (in 2016, PE transactions achieved a volume of €20.8 billion compared to €19.3 billion in 2017 and €17.9 billion in 2018). There is, however, still a way to go to reach the highest level of 2007 again.

1 Volker Land and Holger Ebersberger are partners and Robert Korndörfer is an associate partner at Noerr LLP.
2 EY, Private Equity Transaktionsmarkt in Deutschland, 2. Halbjahr 2018.
3 Mergermarket lists the IPOs (1) Marley Spoon AG, (2) NFON AG, (3) STS Group AG, and (4) Westwing Group AG.
4 See footnote 3.
5 See footnote 3.
6 Ibid.
7 Ibid.
**PE buyouts**

*General development*

In 2018, the aggregate buyout volume for PE transactions reached €17.9 billion.\(^8\) Compared to 2016, in which a volume of €20.8 billion\(^9\) was reached, this is a shortfall of approximately 14 per cent. The number of buyouts did, however, slightly increase from 190 in 2016 to 216 in 2018.\(^10\)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total buyouts by value (billions of euros)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007*</td>
<td>22.7</td>
</tr>
<tr>
<td>2016†</td>
<td>20.8</td>
</tr>
<tr>
<td>2017†</td>
<td>19.3</td>
</tr>
<tr>
<td>2018†</td>
<td>17.9</td>
</tr>
</tbody>
</table>

* Mergermarket; † See footnote 3.

*Severe competition*

Germany remains an attractive market for PE investors and in 2018 PE transactions have continued to be an important driver of the overall M&A activity in the German market. With an aggregate PE deal activity of €17.9 billion\(^11\) in 2018, PE deals contributed a little less than 45 per cent of the aggregate M&A deal activity of €40.5 billion in 2018.\(^12\) This is a significant increase compared to 2017, in which PE transactions contributed approximately 30 per cent to the aggregate M&A activity, and even exceeds the 2016 ratio, in which PE transactions contributed a little less than 40 per cent to the aggregate M&A activity in Germany. This shows that the already strong competition between strategic investors and financial sponsors for targets in Germany is increasing further. One very prominent example of this strong competition is the sales process for the Erwin Hymer Group (€2.2 billion). It was structured as a dual-track bidding contest, in which a number of large players in the PE market participated, including Centerbridge, Cinven, Cerberus, Triton and KPS Capital Partners.\(^13\) In the end the strategic investor Thor Industries won the race.

*Large cap versus small and medium cap*

With an aggregate value of €11.2 billion a large part of the overall buyout value can be attributed to five large cap transactions: (1) the sale of Techem (€4.6 billion)\(^14\) to Partners Group, Caisse de dépôt et placement du Québec (CDPQ) and Ontario Teachers’ Pension Plan (OTPP), being the largest PE acquisition in Germany so far,\(^15\) (2) the sale of SUSE Linux (€2.2 billion)\(^16\) to EQT Partners AB, (3) the sale of Scandlines (€1.7 billion)\(^17\) to First State Investments and Hermes Investment Management, (4) the sale of a 89.9 per cent stake

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\(^8\) Ibid.
\(^9\) Ibid.
\(^10\) Ibid.
\(^11\) Ibid.
\(^12\) Ibid.
\(^14\) Mergermarket.
\(^16\) Mergermarket.
\(^17\) Ibid.
in Generali Lebensversicherung (€1.9 billion)\textsuperscript{18} to Cinven Partners, and (5) the sale of HSH Nordbank (€1 billion)\textsuperscript{19} to an investor group around Cerberus Capital Management and JC Flowers & Co LLC.

The major part of the overall deal activity were small and medium cap transactions with an aggregate value of €6.9 billion. Whereas this only reflects the transactions that are disclosed, the actual volume will be significantly higher, as in particular small and mid cap focused PE investors tend to keep the acquisition value secret.

**Industries**

In terms of industries, the highest transaction value was achieved in the sector of other services (€5.9 billion)\textsuperscript{20} followed by financial services (€3.1 billion),\textsuperscript{21} information technology (€2.8 billion),\textsuperscript{22} transportation and logistics (€2.1 billion)\textsuperscript{23} and pharma and healthcare (€1.7 billion).\textsuperscript{24} In 2016, the top two industries that attracted PE investors were chemicals (€4.1 billion)\textsuperscript{25} and real estate (€3.3 billion).\textsuperscript{26}

In terms of number of deals the information technology sector attracted most financial sponsors, with 30 transactions, which is in line with figures in 2016, in which the largest number of transactions was also attributable to the information technology sector (15).\textsuperscript{27} The information technology sector is followed by other services (25), pharma and healthcare (23), financial services (7) and transportation and logistics (4).\textsuperscript{28}

The above figures show, that in particular the interest in the healthcare sector has increased over the past two years. As prominent example Nordic Capital announced in 2017/2018 the acquisition of Alloheim, the second largest private German care home operator\textsuperscript{29} for about €1.1 billion.\textsuperscript{30} In early 2018, Nordic Capital also announced the formation of European dental clinic platform by acquiring several brands in Germany and Europe, including DPH Dental, Zahnstation and Adent and Dental Clinics.\textsuperscript{31}

**Exits (other than IPOs)**

The number of exits remains with 112 on the same level as in 2016.\textsuperscript{32} There is still quite a shift from sales to strategic investors to sales to PE investors. Although the overall relevance of secondary buyouts has slightly decreased compared to 2017, the overall trend that PE investors take a decision in form of a secondary buyout remains unbroken. In 2016 around

70 per cent of all exits and approximately 65 per cent of the value of these exits were made to strategic investors. In 2018 less than 60 per cent of all exits and only approximately 30 per cent of the value of these exits related to transactions with a strategic buyer. In total the number of secondary buyout transactions increased compared to 2016 by around 26 per cent from 38 in 2016 to 48 in 2018.33

Two of the most prominent secondary buyouts in 2018 were (1) the €4.6 billion sale of Techem by Macquarie to Partners Group, CDPQ and OTPP, and (2) the €1.7 billion sale of Scandlines by 3i to First State Investments and Hermes Investment Management.

<table>
<thead>
<tr>
<th>Sales to strategic investors (value in billions of euros, and number)</th>
<th>2007*</th>
<th>2016†</th>
<th>2017†</th>
<th>2018†</th>
</tr>
</thead>
<tbody>
<tr>
<td>€16.8 billion</td>
<td>€13.1 billion (74)</td>
<td>€8.1 billion (60)</td>
<td>€4.4 billion (64)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Secondary buyouts (value in billions of euros, and number)</th>
<th>2007*</th>
<th>2016†</th>
<th>2017†</th>
<th>2018†</th>
</tr>
</thead>
<tbody>
<tr>
<td>€14.8 billion</td>
<td>€7.1 billion (38)</td>
<td>€7.5 billion (53)</td>
<td>€10 billion (48)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total</th>
<th>2007*</th>
<th>2016†</th>
<th>2017†</th>
<th>2018†</th>
</tr>
</thead>
<tbody>
<tr>
<td>€31.6 billion</td>
<td>€20.5 billion</td>
<td>€15.6 billion</td>
<td>€14.4 billion</td>
<td></td>
</tr>
</tbody>
</table>

* Mergermarket; † See footnote 3.

ii Operation of the market

Sales process

As in previous years, in 2018, a large number of transactions were structured as bidding contests, in many cases including a dual-track process. While an IPO is generally still considered a viable option for an exit, 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. One-on-one transactions are still the exception, which again shows that the market remains seller-friendly. With unprecedented amounts of dry powder in the market34 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. A prominent example is the acquisition of SUSE Linux by EQT for €2.2 billion, achieving an earnings before interest, tax, depreciation and amortisation (EBITDA) multiple of approximately 25.35 This high pricing level is in addition accelerated by the tendency that more and more strategic investors are willing, and able, to match offers by PE-backed bidders. On the other hand, investment committees of PE investors increasingly look very carefully at investment stories, in particular in a high-price market such as Germany.

33 Ibid.
35 See footnote 15.
**Warranty and indemnity insurance**

The year 2018 showed that warranty and indemnity (W&I) insurances have again found their place, particularly in structured large and mid cap sales processes. 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. 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 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.

Because of the high demand for W&I insurances, the W&I solutions offered have become more and more sophisticated, and are also extending to regulated industries (such as financial services) for which it was hardly possible to obtain coverage a few years ago. Also the tickets that insurers are willing to cover have increased over the years. In particular, in large cap transactions the W&I insurance limits are increased by building ‘towers’, with several layers of insurance limits offered by a consortium of insurers.

**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, profit participations etc. 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 1 to 1.5 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.

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 became more common in 2018.

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 above) 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 Germany Stock Corporation Act (AktG) 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.36 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 of the 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 Directive37 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 (AIFs). 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 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

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36 German Federal Court of Justice (BGH), NZG 2017, p. 344.
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 special purpose vehicle (Section 287 Paragraph 2 KAGB, Section 2 of the annex to the 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 2018. Although the overall transaction value slightly decreased compared to the totals in 2016 and 2017, the number of transactions remained stable and even increased compared to 2016 (see Section I).

Providing another indicator of the continued importance of the German market for PE investors, several important players in the market decided to open new offices in Germany in 2018. As the German Mittelstand becomes more and more a focus of PE investors, and with small and medium-sized transactions proving difficult to coordinate out of European centres such as London or Paris, opening a local office in Germany has become an attractive solution. In early 2018, KKR announced that it would open an office in Frankfurt. The office finally opened in September 2018. The mid market-focused British PE investor Oakley Capital Private Equity opened an office in Munich, also in September 2018, underlining the relevance of the German market and the rest of the DACH region. Other participants, such as Gilde Healthcare and FSN Capital, are also building up teams in Frankfurt.

### ii Financing

In 2018, the financing trends that were seen in 2016 and 2017 continued. It has become common that LBO financings provide for one (maintenance) financial covenant only (typically a net leverage covenant). ‘Covenant-lite’ structures, which, until 2018, had not been seen in the German mid market, were successfully negotiated by PE investors in some (but very few) transactions. As the vast majority of mid-market LBO financings still provide for one financial covenant, PE investors continued to be focused on covenant headroom and EBITDA adjustments, such as cost savings and cost or revenue synergies, as well as extraordinary items. In this respect, the trend for increased headroom (often more than 30 per cent – or 35 per cent for unitranche financings) and EBITDA adjustments (often up

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38 See footnote 15.
41 The neighbouring countries of Germany (D), Austria (A) and Switzerland (CH), which represent the largest community where German acts as the de facto nationwide official language.
43 See footnote 15.
to 20 per cent of the consolidated EBITDA) continued. In addition, some 2018 mid-market LBO financings provide for EBITDA cures, a feature absent from the market since 2008. Further, also in 2018, debt funds were able to increase their market share in the German mid market. Financing provided by debt funds for German mid-market LBOs made up about 50 per cent of mid-market LBO debt, compared to about 35 per cent in 2017.\footnote{See GCA Altium MidCap Monitor Q3 2018.} Depending on events impacting on credit markets generally (such as political and economic uncertainty), this trend can be expected to continue, as debt funds become increasingly able to underwrite large debt volumes (€300 million plus)\footnote{Ibid.} and the number of banks lending alongside debt funds in the German LBO market by providing a super senior revolving credit facility (combined with a first-out term loan, as the case may be) increased once more in 2018. In this context, it can be noted that intercreditor positions between debt funds and banks lending on a super senior basis have become fairly standardised (based on Loan Market Association-based intercreditor agreements) and, hence, in most unitranche or super senior financings, only very limited intercreditor negotiations are to be expected.

### iii Key terms of recent control transactions

#### Sale of Techem (€4.6 billion) to Partners Group, CDPQ and OTPP


#### Sale of SUSE Linux (€2.2 billion) to EQT Partners AB

In July 2018, the EQT VIII fund acquired SUSE, a leading global provider of open-source infrastructure software for large enterprises, from the global infrastructure software business Micro Focus International plc (Micro Focus) for an enterprise value of €2 billion. SUSE is a German provider of an enterprise-grade open-source Linux operating system, with sales of US$320 million and about 1,400 employees. The transaction is subject to approval by Micro Focus shareholders, and customary regulatory approvals, and is expected to be closed in the first quarter of 2019.\footnote{https://www.eqtpartners.com/news/Press-Releases/2018/eqt-to-acquire-leading-open-source-software-provider-suse/} EQT is a leading investment firm with approximately
€50 billion in raised capital across 27 funds. EQT funds have portfolio companies in Europe, Asia and the United States, with total sales of more than €19 billion and approximately 110,000 employees. 49

**Sale of Scandlines (€1.7 billion) to First State Investments and Hermes Investment Management**

In March 2018, 3i and funds managed by 3i (together, Eurofund V), sold their investment in Scandlines for a total equity value of €1.7 billion, in a transaction with funds managed by First State Investments and Hermes Investment Management, two long-term infrastructure investors representing predominantly European pension funds. As part of the transaction, 3i is also reinvesting in Scandlines. The acquisition was completed in June 2018. Scandlines is engaged in ferry transportation services. 50

**Sale of an 89.9 per cent stake in Generali Lebensversicherung (€1.7 billion) to Cinven Partners**

In July 2018, the Sixth Cinven Fund agreed to acquire the Viridium Group, a leading specialist for the management of life insurance portfolios in Germany, and to provide equity funding for Viridium to acquire Generali Lebensversicherung AG, a life insurer with around 4 million policies and approximately €40 billion of assets under management, in a transformational acquisition. 51 The total transaction value for Generali amounts to approximately €1 billion, including earn-outs of €125 million. 52 The transaction is subject to approval by the German Federal Financial Supervisory Authority and clearance by the competent German antitrust authorities. 53

**Sale of HSH Nordbank to an investor group around Cerberus Capital Management and JC Flowers & Co LLC**

In February 2018, the Free and Hanseatic City of Hamburg and the state of Schleswig-Holstein sold their stake in HSH Nordbank AG for a consideration of approximately €1 billion. The purchasers are the independently acting funds of Cerberus European Investments, JC Flowers & Co, GoldenTree Asset Management and Centaurus Capital, as well as BAWAG. The acquisition was closed in November 2018. Hence, HSH Nordbank AG is the first successfully privatised Landesbank (or government-owned bank) in Germany. 54 Cerberus Capital Management is a global leader in alternative investing, with more than US$34 billion under management across complementary credit, PE and real estate strategies. JC Flowers & Co is a leading private investment firm dedicated to investing globally in the financial services industry. 55

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49 Ibid.
50 https://www.3i.com/media/3454/scandlines-final-260318.pdf; Mergermarket.
52 Mergermarket.

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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; and (2) at least two companies had domestic revenues of which one company's was more than €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. 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.

ii Foreign investment

In the case of a foreign PE investor acquiring a target in Germany, the transaction may be subject to review by the German Federal Ministry of Economic Affairs and Energy in accordance with the German Foreign Trade Act in conjunction with the German Foreign Trade Act.

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57 Ibid.
Trade Ordinance. On 19 December 2018, the German government once again extended the rules on foreign investment in Germany. As recently as mid 2017, the federal government had already significantly broadened the rules. The newest reform essentially has two effects:

a The threshold for investments in certain types of critical infrastructure, defence companies and IT security companies is lowered from 25 per cent to 10 per cent. In other words, a foreign investor is now subject to the rules on investment control if it acquires shares of 10 per cent or more in one of the companies operating in these areas.

b With immediate effect, media companies are also deemed equivalent to critical infrastructure, so that (1) the threshold of 10 per cent described above also applies, (2) there is a reporting requirement for the acquisition of media companies, and (3) there is an indication that it jeopardises public order or security.

This second tightening of the foreign investment rules within a short period by the German government might have a significant impact on PE transactions in Germany as it broadens tremendously the filing requirements under German law. This will also have to be considered when structuring the sales process as the periods for a potential closing might be significantly longer.

iii Act on the Transposition of the Second Shareholder Rights Directive

As a consequence of European Directive 2017/828/EU, there will be changes to the AktG. The changes affect not only the stock corporations themselves but also institutional investors and asset managers. According to the Directive, and the draft of the implementation law of the German Federal Ministry of Justice issued in October 2018 (the Act on the Transposition of the Second Shareholder Rights Directive (ARUG II)), institutional investors as well as asset managers shall develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy. Additionally they have to disclose on an annual basis how their engagement policy has been implemented, including a general description of voting behaviour, an explanation of the most significant votes and the use of the services of proxy advisers. However, the implementation of these requirements is not mandatory. If the institutional investor or asset manager chooses not to comply with these requirements, that institutional investor or asset manager must publish a clear and reasoned explanation.

On top of that, institutional investors and asset managers shall disclose how the main elements of their equity investment strategy comply with the duration of their liabilities and how those strategy elements contribute to the performance of their assets.

However, these new requirements will only apply for institutional investors and asset managers who invest in shares traded on a regulated market in the sense of Article 4 Section 1 No. 21 Directive 2014/65/EU (known as MiFID II). Furthermore the measures of the implemented law under the AktG will only apply for institutional investors and asset managers registered in Germany. Ultimately, the impact of ARUG II on the PE industry will be very limited but will have to be considered at the level of potential portfolio companies within the scope of application. According to Section 134a Paragraph 1 of the German draft legislation, institutional investors means an undertaking carrying out activities of

59 Ibid.
life insurance and of reinsurance or an institution for occupational retirement provision. To be considered an asset manager within the meaning of the law, the undertaking must be a financial services institution with permission to perform portfolio management in the sense of Section 1 Paragraph 1a No. 3 of the German Banking Act or a capital management company possessing an authorisation to conduct business according to Section 20 Paragraph 1 of the KAGB.

V OUTLOOK

After a promising first half-year, which indicated a possible new peak in PE investing in Germany since the crash in 2007, in the end 2018 did not meet these expectations. The second half of 2018 showed a significant decrease of buyout activity, both in terms of volume and number of transactions. Although the overall level of PE activity in Germany remains at a high level, to a certain extent the slowdown comes as a surprise. Although at first glance this might be attributed to macroeconomic factors such as the United Kingdom steering towards an unpredictable Brexit or the success of right-wing parties in Europe (such as the AFD in Germany), to a certain extent it contradicts the overall development on a European level, which reached an all-time post-crash high in 2018, with overall buyout activity in Europe reaching US$195.5 billion (1,458 buyouts).60 This applies in particular as the general trend for conservative politics, both in European countries and in US policies, affects all Europe, and Germany is in certain respects rather deemed to be one of the potential beneficiaries of Brexit.

It remains to be seen whether, in 2019, the high level of PE transactions will be sustained or even increased. With unprecedented amounts of dry powder in the market and the continued low interest policy of the ECB, the market at least has sufficient liquidity to foster a successful 2019.

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60 Mergermarket.
Chapter 7

INDIA

_Raghbir Menon and Taranjeet Singh_

I OVERVIEW

All previous records were surpassed in 2018 with the crossing of the US$100 billion mark in terms of deal value across both private equity (PE) and strategic (M&A) transactions. Incubated by several big ticket structural and regulatory reforms – including overhaul of the indirect tax regime through the new Goods and Services Tax (GST), the liberalisation of foreign direct investment, the introduction of the Real Estate Regulatory Authority (RERA) as a real estate sector regulator, receipt of approvals from regulators for the first real estate investment trust (REIT), government stimulus to address non-performing assets (NPAs), an effective push for the ‘Make in India’ scheme, and time-bound enforcement of the Insolvency and Bankruptcy Code 2016 (IBC) – investors’ confidence in India’s growth story was reinforced and this was highlighted in the record-breaking deal activity in 2018. It was also a year in which the Indian economy appeared to have shrugged off the after-effects of demonetisation in 2016 and implementation of GST in 2017.

India improved its ranking by 23 points and reached 77th position in the World Bank’s ‘Doing Business 2019’ report. India improved its rank in six out of 10 parameters relating to starting and doing business in the country. 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 2018**

Long-due legal and policy reforms coupled with factors such as 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 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, all acted as catalysts to make 2018 a blockbuster year for deal activity in India. 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.

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The great Indian distressed-asset sale, supplying assets at attractive valuations across a number of core areas, along with increased appetite of investors, SWFs and strategic buyers for control deals, co-investment deals and platform deals, resulted in the highest number of big-billion bets on India’s growth story. Technology, real estate, financial services, energy, telecoms and manufacturing were among the top sectors driving dealmaking activity in 2018.

The second half of the year witnessed choppiness in the markets. Uncertainty and volatility triggered by major political events (including defeats suffered by the ruling central government in assembly elections in key states, and the United States–China trade war), approaching general election, corporate governance lapses in IL&FS triggering bubble bursts in the non-banking financial company (NBFC) sector and creating liquidity concerns, a flurry of bank scams, implementation of long-term capital gains tax, resignation by the governor of the Reserve Bank of India (RBI), an increase in oil prices and depreciation of the rupee, among other factors, led to a sharp market correction in the second half of the year.

**Indian stock markets and foreign portfolio investor and institutional investor sentiment**

As expected, in 2018 equity markets were volatile. India’s macroeconomic variables deteriorated marginally from the unsustainable good levels they enjoyed in 2017. Data from South Korea, Taiwan, India, Thailand, Philippines, Indonesia and Vietnamese stock exchanges showed foreigners sold a net $33.6 billion worth of equities in 2018, which was the biggest outflow from Asian equities in the past seven years. Foreign portfolio investors (FPIs) and foreign institutional investors (FIIs) have been among the biggest drivers of India’s financial markets and invested around 12.51 trillion Indian rupees in India between the financial years 2002 and 2018. In 2018 (up to 31 December 2018), FIIs and FPIs pulled approximately 940.7 billion rupees from the Indian financial markets.

The constant raising of rates by the central banking system of the United States, the US Federal Reserve System (1.25 per cent from 0.75 per cent in 2017, and further raised to 2.5 per cent in 2018), coupled with factors such as tariff wars, a spike in crude prices, the dollar stronger against other currencies (especially the rupee), Brexit, IL&FS issues leading to liquidity concerns for NBFCs, state elections and upcoming general election, were all contributors to India losing its sheen as an investment destination for hot FPI/FII money. The US Federal Reserve is also expected to raise the rate to 3 per cent in 2019 and 3.5 per cent in 2020, which could make FPIs pull more money out from India.

However, despite heavy volatility, coupled with foreign fund outflows and a weak rupee, the Indian equities market emerged as one of the best performers globally in 2018.4

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7 Ibid.
11 See footnote 8.
Barring India, almost all major markets closed 2018 having lost ground compared with a year ago. Although the 2018 gains were marginal, both the Sensex and Nifty 50 indices emerged as among the best in attaining the highest growth rates globally.

Impact of outflow of foreign funds was cushioned to a large extent by huge participation by domestic institutional investors (DIIs), either directly or through mutual funds. Investments by DIIs reached approximately US$14 billion in 2018. The total number of investor accounts with 41 active mutual fund houses rose to a record 79.03 million at the end of October 2018, as against 71.35 million in March 2018, according to the data from the Association of Mutual Funds in India (AMFI). AMFI is targeting nearly five-fold growth in assets under management (AUM) to US$1.30 trillion and more than three times growth in investor accounts to 130 million by 2025. India has witnessed investments of approximately US$1 billion in systematic investment plans alone, and markets have reached a stage where DIIs have been injecting approximately US$10 billion to US$12 billion each year merely from mutual funds.

**Dealmaking in India**

The year 2018 saw record deal-making activity in India and as at December 2018 the amount in value of India’s M&A and PE activity had crossed the US$100 billion mark, in 1,640 transactions. Strategic deals were the fulcrum of this landmark year for M&A activity in India, with recorded investments worth US$71.3 billion, compared to US$34.6 billion in 2017. Walmart and Schneider were among the key global contributors to M&A deal value. Inbound activity accounted for 30 per cent (approximately US$21.7 billion) of M&A deal value this year, which was six times the deal value of 2017. Consolidation to achieve size, scalability, new product portfolios and better operating models catapulted deal activity upward in the M&A space, accounting for around 50 per cent of total transaction value in 2018.

The downward trend in deal volume continued with 2018 recording 1,640 transactions compared to 1,824 in 2017 and 2,030 in 2016. However, deal values surged upward in 2018, with 21 billion-dollar deals across both PE and strategic deals combined, which is double the number recorded in 2017.

According to the PwC report ‘Deals in India: Annual review and outlook for 2019’, an increase in value of nearly 25 per cent compared to 2017 was witnessed 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.\textsuperscript{21}

**PE dealmaking**

There was a sharp unprecedented uptick in the value of PE and venture capital (VC) investments in India in 2018 on account of some very large deals (12 deals of US$500 million in value or greater, including eight US$1 billion plus deals).\textsuperscript{22} According to the EY report 'PE/VC Annual Roundup – 2018', investments increased by 35 per cent in value terms compared to 2017 (US$35.1 billion compared to US$26.1 billion in 2017) and deal volume increased by 28 per cent (761 deals compared to 594 deals in 2017).\textsuperscript{23}

Continuing the trend of the past years, in terms of numbers (by value and volume) large deals saw an increase in 2018. Totalling US$25.9 billion in aggregate, there were 76 deals of value greater than US$100 million in 2018, which accounted for 74 per cent of total PE/VC investments made in 2018 compared to 54 deals, aggregating US$18.7 billion, of value greater than US$100 million in 2017.\textsuperscript{24}

**Buyouts**

The growth was led by a strong pickup in buyouts and start-up investments. After a minor decline in 2017, 2018 witnessed a record 48 buyouts worth US$9.8 billion in aggregate, equal to the value of buyouts in the previous three years combined.

**Start-up investments**

On the back of some mega deals, start-up investments gained momentum in 2018 after subdued investments in 2016 and 2017. The comeback was on account of large VC investors such as Softbank, Tencent and Naspers deploying significant amounts of capital, making 2018 the best year for start-ups, and eclipsing 2015. Investment in start-ups increased 83 per cent in 2018 to US$6.4 billion compared to US$3.5 billion in 2017.\textsuperscript{25}

**Growth investments and public investment in private equity deals**

An increase of 3 per cent in terms value was recorded in public investment in private equity (PIPE) deals, at US$3.9 billion in 2018, whereas, growth investments recorded a decline of 5 per cent and saw their share of the total investment pie decline to 36 per cent (compared to over 50 per cent in prior years, at US$12.7 billion).\textsuperscript{26}

**Exits**

The year 2018 was a record one for exits, with PE/VC exits reaching US$26 billion, nearly doubling from the year before, and almost equal to the value of exits in the previous three years.

\textsuperscript{21} Ibid.
\textsuperscript{23} Ibid.
\textsuperscript{24} Ibid.
\textsuperscript{25} Ibid.
\textsuperscript{26} Ibid.
India

years combined. Walmart’s big-billion bet on India’s growth story in its acquisition of a controlling stake in Flipkart for US$16 billion from its exiting investor group, including Softbank, Tiger Global and others, contributed significantly to the value of exits in 2018. According to EY, both open market exits and PE-backed initial public offerings (IPOs) saw a decline because of choppiness in stock markets.

Indian investment market debuts

In addition to record investment in the start-up sector, 2018 also saw debuts by the following international investors in India (mostly making bets on the Indian start-up ecosystem):  a Morningside Venture Capital, one of China’s oldest early-stage venture investors, and with around US$1.7 billion under management, made its debut in India this year with investments in Dreamplug Technologies, Sharechat and Cashify.

b Composite Capital Management, a Hong Kong-based investment firm, made its first investment in India in Cleartax.in.

c RDGlocal, a fund led by former top executives of Chinese internet giant Alibaba, opened its account in India by investing in Welike.

d Sailing Capital, a Hong Kong-based private equity fund, marked its entry into India when it co-invested US$50 million in cab aggregator Ola. Sailing Capital and the China-Eurasia Economic Cooperation Fund, a Chinese state-backed investment fund, took a combined stake of more than 1 per cent in Ola.

e Dentsu Ventures, a Japanese corporate VC fund, made its first investment in India in bus shuttle service provider Shuttl.

f Berkshire Hathaway, one of the biggest names in the investment world, opened its India account by investing US$300 million in One97 Communications Ltd.

g Mithril Capital Management made its first bet in India by leading a US$140 million funding round in GreyOrange, which handles warehousing for companies such as Flipkart, Jabong, Myntra and PepperFry.

h Northpond Ventures, a US-based VC firm, led a US$40 million Series C funding round in Bengaluru-based oncology solutions company Mitra Biotech.

i Think Investments, a US-based private investment firm, took its first plunge in India by participating as a lead in the US$50 million Series C round of funding in Mumbai-based health-tech startup PharmEasy.

j Insight Venture Partners, a global VC firm based in the United States, made its maiden investment in India in Chargebee, a software-as a-service subscription management company based in Chennai.

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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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

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33 See footnote 31.
35 See footnote 29.
employees seeking an equity stake in the company, phantom stock options may not be an 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.36

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.37

The Securities and Exchange Board of India (SEBI), in October 2016, 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. SEBI in January 2017 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.38

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,

36 Ibid.
37 http://www.mondaq.com/india/x/758126/Shareholders/The+Ups+And+Downs+Of+UpsideSharing+Structures+In+India.
38 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).
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.\textsuperscript{39}

**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 exits happened through strategic sales, which grew sevenfold from 2017, while open-market transactions fell by more than half in 2018.\textsuperscript{40}

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:

\begin{itemize}
\item[a] an approach is made by the seller’s investment banker to potential buyers;
\item[b] a non-disclosure agreement is executed;
\end{itemize}

\textsuperscript{39} See footnote 37.

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.

**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 markups 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 IBC. 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 ICC, LCIA and SIAC) 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 non-banking financial companies (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 venture capital fund (VCF), alternative investment fund (AIF), REIT or infrastructure investment trust (or 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
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 consolidated FDI policy (the FDI Policy) dated 4 January 2018, issued by the Department of Industrial Policy and Promotion (DIPP), and the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2017 (FEMA20R). Previously, any investment in excess of the sectoral caps or not in compliance with the sectoral conditions required prior approval from 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 taken previously 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 to be followed by investors and various government departments to approve foreign investment proposals.

**Foreign portfolio investor 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 obtaining prior registration as a foreign portfolio investor (FPI) from a Designated Depository Participant (DDP) pursuant to the SEBI (Foreign Portfolio Investors) Regulations 2014 (the FPI Regulations). 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, the securities watchdog, namely SEBI, introduced the FPI Regulations. FPIs must be registered with a DDP before dealing with securities as an FPI.

**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 these entities into listed Indian companies is also permitted subject to certain limits or conditions. Investment by the FVCI route requires prior registration with SEBI under the Securities and Exchange Board of India (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. FVCIs should obtain a registration from SEBI before making investments pursuant to the FVCI Regulations. The process typically takes 20 to 30 days from the date of application. To promote job creation and innovation, the RBI has allowed for 100 per cent FVCI investment in start-ups. Previously, it was restricted to biotechnology, information technology (IT), nanotechnology, seed research and development, the discovery of new chemical entities in the pharmaceutical sector, the dairy industry, poultry industry, production of biofuels, hotels and convention centres with a seating capacity of over 3,000, and the infrastructure sector; the approval of the securities regulator was not needed for investment in these sectors.
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 avoidance treaty (or 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.\(^4\)

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.\(^5\)

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. 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 tax exemption.

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\(^5\) Ibid.
structuring investments out of tax havens. Once a transaction falls foul of 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.43

**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,44 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’.45 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 per cent 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:

- to act in accordance with the articles of the company;
- 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;
- to act with due and reasonable skill, care, diligence, and exercise independent judgement;
- not to be involved in a situation that may lead to a direct or indirect conflict or possible conflict of interest with the company;
- 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
- 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:

- be inquisitive, peruse agendas for unusual items and seek additional information in writing, if necessary;
- ensure that disagreements or dissenting views are recorded in the minutes;

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43 Ibid.
44 Circular No. 6 of 2017 dated 24 January 2017 issued by the Central Board of Direct Taxes.
45 Ibid.
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;

seek professional advice, engage external agencies, if the situation demands it;

regularly provide requisite disclosures of interests or conflicts, consider excusing oneself from participation in proceedings in cases of conflict; and

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

With M&A and PE activity crossing the US$100 billion mark in 1,640 transactions, 2018 was a watershed year for dealmaking in India.

According to EY, most of the sectors recorded significant increases in value invested, with 11 sectors recording over US$1 billion in investments, compared to seven such sectors in 2017. Financial services remained the most busy, with 141 deals receiving US$7.5 billion (a 6 per cent increase over 2017), followed by the real estate sector receiving US$4.5 billion across 49 deals (a 10 per cent decline compared to 2017) and e-commerce witnessing 83 deals, worth US$4.3 billion (a 9 per cent decline compared to 2017). Other key sectors seeing investments included industrial products (US$1.6 billion across 21 deals compared to US$62 million across six deals in 2017), food and agriculture (US$1.8 billion in 45 deals compared to US$364 million across 47 deals in 2017), retail and consumer products (US$1.9 billion across 41 deals against US$678 million across 36 deals in 2017) and education (US$843 million across 38 deals in 2018 versus US$253 million across 20 deals in 2017).

**PE investments (other than real estate and infrastructure)**

The largest PE investment deal during the year saw Singapore’s sovereign fund GIC, private equity giant KKR, PremjiInvest and Canadian pension fund OMERS investing US$1.7 billion in HDFC Ltd for a 3 per cent stake. In another staggering PE deal, PE giant Warburg Pincus along with five major global investors, including Temasek, Singtel and SoftBank, invested US$1.25 billion in Bharti Airtel's Africa unit.

UPL Corporation’s US$4.2 billion acquisition of US-based Arysta LifeScience was in turn given a shot in the arm by a US$1.2 billion investment by Abu Dhabi Investment

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46 See footnote 22.
47 Ibid.
48 See footnote 27.
Group and TPG in UPL Corporation. Japanese investment giant Softbank remained bullish on the growth story of India’s IT and IT enabled services sector and reinforced this belief by leading a US$1 billion investment in budget hospitality chain Oyo. South Africa’s Naspers also placed big bets on Indian tech start-ups, and in back-to-back deals led a US$1 billion investment in food-tech ‘unicorn’ Swiggy and, along with CPPIB and General Atlantic, a US$450 million funding round in edtech firm Byju’s.

On the basis of EY’s ‘PE/VC Annual Roundup – 2018’, the following were the top PE investments (excluding infrastructure and real estate) in the past year.\(^{49}\)

<table>
<thead>
<tr>
<th>Company</th>
<th>PE investor</th>
<th>Sector</th>
<th>Stage</th>
<th>US$ (millions)</th>
<th>Stake</th>
</tr>
</thead>
<tbody>
<tr>
<td>HDFC</td>
<td>GIC, KKR, Premjiinvest, OMERS and others</td>
<td>Financial services</td>
<td>PIPE</td>
<td>1,731</td>
<td>3%</td>
</tr>
<tr>
<td>Airtel Africa Ltd</td>
<td>Warburg Pincus, Temasek, SingTel Innov8, SoftBank</td>
<td>Telecom</td>
<td>Growth capital</td>
<td>1,250</td>
<td>28%</td>
</tr>
<tr>
<td>UPL Corporation Ltd</td>
<td>Abu Dhabi Investment Council, TPG</td>
<td>Food and agriculture</td>
<td>Growth capital</td>
<td>1,200</td>
<td>22%</td>
</tr>
<tr>
<td>Oravel Stays Pvt Ltd</td>
<td>Lightspeed Venture, Sequoia Capital, SoftBank and others</td>
<td>E-commerce</td>
<td>Start-up or early stage</td>
<td>1,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Bundl Technologies Pvt Ltd</td>
<td>DST Global, Naspers, Tencent Hillhouse Capital and others</td>
<td>E-commerce</td>
<td>Start-up or early stage</td>
<td>1,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Star Health and Allied Insurance Co. Ltd</td>
<td>Madison India, Westbridge Capital</td>
<td>Financial services</td>
<td>Buyout</td>
<td>1,000</td>
<td>94%</td>
</tr>
<tr>
<td>Vivtera Global Business Services LLP</td>
<td>Warburg Pincus</td>
<td>Technology</td>
<td>Start-up or early stage</td>
<td>1,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Larsen &amp; Toubro's Electrical and Automation business</td>
<td>Temasek (balance stake with Schneider Electric)</td>
<td>Industrial products</td>
<td>Growth capital</td>
<td>760</td>
<td>35%</td>
</tr>
<tr>
<td>Vishal Mega Mart</td>
<td>Partners Group, Kedaara</td>
<td>Retail and consumer products</td>
<td>Buyout</td>
<td>734</td>
<td>100%</td>
</tr>
<tr>
<td>Think and Learn Pvt Ltd (Byju)</td>
<td>General Atlantic, Naspers and CPPIB</td>
<td>Education</td>
<td>Growth Capital</td>
<td>540</td>
<td>N/A</td>
</tr>
</tbody>
</table>

**Infrastructure and real estate**

Driven by a clean-up of the sector on account of the implementation of RERA and demonetisation, the successful receipt of SEBI clearance for a US$600 million REIT by Blackstone-backed Embassy Group, and availability of attractive yield-generating commercial assets, the real estate sector witnessed increased PE interest from domestic and foreign funds. The infrastructure sector made a comeback in 2018, on account of big global SWFs and strategic investors such as Macquarie, CPPIB, Brookfield and PSP showing an appetite to acquire good quality assets.

Macquarie bought toll-operate-transfer road assets auctioned by the National Highways Authority of India (NHAI) for US$1.4 billion in one of the largest PE deals of 2018. According to the EY report, the following were the top infrastructure and real estate investments in 2018.\(^{50}\)

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\(^{49}\) See footnote 22.

\(^{50}\) Ibid.
India

<table>
<thead>
<tr>
<th>Company</th>
<th>PE investor</th>
<th>Stage</th>
<th>US$ (millions)</th>
<th>Stake</th>
</tr>
</thead>
<tbody>
<tr>
<td>NHAI road assets</td>
<td>Macquarie</td>
<td>Buyout</td>
<td>1461</td>
<td>N/A</td>
</tr>
<tr>
<td>Equinox Business Park</td>
<td>Brookfield</td>
<td>Buyout</td>
<td>384</td>
<td>N/A</td>
</tr>
<tr>
<td>SP Infocity, IT Park</td>
<td>Temasek</td>
<td>Buyout</td>
<td>353</td>
<td>N/A</td>
</tr>
<tr>
<td>Phoenix’s Hyderabad office project</td>
<td>Xander</td>
<td>Buyout</td>
<td>350</td>
<td>100%</td>
</tr>
<tr>
<td>Indiabulls Properties Pvt Ltd</td>
<td>Blackstone</td>
<td>Buyout</td>
<td>346</td>
<td>50%</td>
</tr>
<tr>
<td>Hamstede Living Pvt Ltd, a joint venture with</td>
<td>Warburg Pincus</td>
<td>Buyout</td>
<td>291</td>
<td>68%</td>
</tr>
<tr>
<td>Lemontree</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Wadhwa Group</td>
<td>Piramal Fund Management</td>
<td>Credit investment</td>
<td>235</td>
<td>N/A</td>
</tr>
<tr>
<td>Three developers’ projects</td>
<td>Piramal Capital</td>
<td>Credit investment</td>
<td>214</td>
<td>N/A</td>
</tr>
<tr>
<td>Azure Power India Pvt Ltd</td>
<td>CDPQ, IFC, Helion</td>
<td>Growth capital</td>
<td>185</td>
<td>N/A</td>
</tr>
<tr>
<td>Island Star Mall Developers Pvt Ltd (Phoenix</td>
<td>CPPIB</td>
<td>Growth capital</td>
<td>185</td>
<td>N/A</td>
</tr>
<tr>
<td>Mills joint venture)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Limited partners, SWFs, pension funds, PIPE deals and platform plays

India attracted 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 2018, contributing around US$6.5 billion to PE deal value for the year. This is over double the value of transactions five years ago. SWFs have been relatively active in the renewables 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, possibly spurring competition with the VC community.51

LPs who traditionally were 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 (or 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 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.52

51 See footnote 2.
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 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 CPPIB, Abu Dhabi Investment Authority and Qatar Investment Authority, have demonstrated tremendous appetite for creating new platforms.53

The investor-friendly modifications to REIT regulations have resulted in global investors like Blackstone, Brookfield and SWFs like GIC Singapore picking up large quality office assets to build up their REIT portfolios. 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.54

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, 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’.55

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 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.56
**Distressed-asset space – the IBC and ARCs**

The IBC 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 IBC 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 NPAs. The IBC gave teeth to the efforts to reform the banking and financial sector. Stressed assets have spied 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 CPDQ, 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. 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. Edelweiss Financial Services Ltd in January 2019 closed its distressed-assets-focused fund EISAF II, raising a corpus of US$1.3 billion, 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 IBC mechanism) belonged to strategic participants, who emerged on top because of their ability to bid higher, and with a longer time horizon, than PE investors. The US$7.5 billion acquisition of bankrupt Bhushan Steel Ltd by Tata Steel Ltd was not only the second-largest M&A deal of 2018 in India, but also the first, and most important, deal that


60  See footnote 2.
stemmed out of the new IBC. PE-backed ARCs also saw the first action in the IBC space, when AION Capital-backed JSW Steel emerged as successful bidder and clinched bankrupt Monnet Ispat and Energy Limited at 28.75 billion rupees. It is expected that the next cycle of IBC resolutions will see greater participation from PE investors on account of factors such as: (1) PE investors picking up important tricks of the trade in the first phase of stressed-asset sales; (b2) banks being expected to take bigger haircuts; and (3) the stressed-asset market in India maturing after rectification of loopholes and teething problems in the IBC space.

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 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. The investors are the key driving factors behind this paradigm shift: (1) they want to achieve better corporate governance; (2) there has been a significant increase in the expertise

and in capability of PE investors to add value to their portfolio companies operationally; (3) they want better operational control; (4) they want to generate better returns on their investments; (5) they want more control over exit opportunities and processes; (6) there has been an increase in platform deals; (7) there are larger amounts of capital available to invest; and (8) 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:

- **a** 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;
- **b** 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;
- **c** Middle holding period: performance, execution, monitoring of value creation initiatives and selective intervention on key issues; and
- **d** Pre-exit: preparing for a successful exit by ensuring alignment with the promoter and company management.62

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

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62 Ibid.
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.

e In exits by way of an 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 2018

One of the largest control acquisition transactions in 2018 was Walmart Inc agreeing to acquire 77 per cent of Flipkart Pvt Ltd for approximately US$16 billion. Other notable control acquisition transactions in 2018 were Teleperformance SA’s 100 per cent buyout of Intelenet Global Services Pvt Ltd from Blackstone for US$1 billion, and Macquarie acquiring tolling rights to selected NHAI road assets for US$1.4 billion.

iv Exits

The year 2018 is expected to mark an inflection point for the PE/VC industry in India, as exits approach the value of investments, demonstrating that the industry is moving towards mature market standards. In 2018, PE/VC exits, at US$26 billion, increased by almost 100 per cent compared to 2017, and are almost equal to the value of exits in the previous three years combined, according to the EY report. Compared to open-market exits worth US$6.2 billion across 128 deals in 2017, 2018 saw US$1.7 billion in open-market exits across 56 deals (a 70 per cent drop in terms of value and a drop of over 56 per cent in terms of volume). Similarly, 11 PE-backed IPOs worth US$760 million were witnessed in 2017 compared to 21 PE-backed IPOs worth US$1.8 billion in 2017 (a drop of more than 50 per cent, both in terms of value and volume). Buy-backs too were down in 2018, at US$997 million, as against US$1.487 billion in 2017.

Despite obtaining SEBI’s approval to float initial share sales worth over 600 billion rupees in 2018, the year saw only 24 IPOs raising only 309.59 billion rupees. The choppiness in the market is expected to continue until the general election in the first half of 2019. Market experts are of the view that markets may pick up significantly in the second half of 2019 if a stable government is formed following the general election.

According to PwC, strategic sales accounted for the biggest slice of the exits pie. Secondary sales also gained importance within the PE community, with a 37 per cent spike in value compared to 2017.

64 See footnote 22.
66 https://www.livemint.com/Companies/vtRzWQkyDMKZpX0YBWtUw1/India-Inc-raises-Rs-6-trillion-from-equity-debt-markets-in.html.
67 See footnote 2.
According to EY, strategic exits worth US$18.4 billion across 50 deals in 2018 were the highest in terms of value, and considerably more than the value recorded in 2017. Similarly, US$4 billion worth of secondary exits across 41 deals in 2018 recorded a growth of 21 per cent compared to 2017 figures.

The e-commerce sector, with 10 exits worth US$16.4 billion, led from the front in 2018, followed by technology with 24 exits worth US$1.8 billion, and the financial services sector with 34 exits amounting to US$1.5 billion.

The largest strategic sale in the year was that of Walmart buying a controlling stake in Flipkart for US$16 billion from a clutch of investors, including SoftBank Group Corp and Tiger Global, among others. It was the largest-ever deal in the Indian PE/VC market.

According to EY, the following were the top 10 PE/VC exits seen in 2018.

<table>
<thead>
<tr>
<th>Company</th>
<th>Sector</th>
<th>Sellers</th>
<th>Buyer</th>
<th>Exit type</th>
<th>US$ (millions)</th>
<th>Stake</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flipkart Pvt Ltd</td>
<td>E-commerce</td>
<td>Softbank, Tiger, Naspers, Accel, IDG and others</td>
<td>Walmart Inc</td>
<td>Strategic</td>
<td>16,000</td>
<td>77%</td>
</tr>
<tr>
<td>Intelenet Global Services Pvt Ltd</td>
<td>Technology</td>
<td>Blackstone</td>
<td>Teleperformance SA</td>
<td>Strategic</td>
<td>1,000</td>
<td>100%</td>
</tr>
<tr>
<td>Vishal Mega Mart Pvt Ltd</td>
<td>Retail and consumer products</td>
<td>TPG Capital and others</td>
<td>Partners Group, Kedaara Capital</td>
<td>Secondary</td>
<td>769</td>
<td>N/A</td>
</tr>
<tr>
<td>Star Health and Allied Insurance Co Ltd</td>
<td>Healthcare</td>
<td>Motilal Oswal, Apis Growth, Sequoia and others</td>
<td>Madison India, Westbridge Capital and others</td>
<td>Secondary</td>
<td>745</td>
<td>70%</td>
</tr>
<tr>
<td>Ostro Energy Pvt Ltd</td>
<td>Power and utilities</td>
<td>Actis</td>
<td>ReNew Power Ventures</td>
<td>Strategic</td>
<td>692</td>
<td>N/A</td>
</tr>
<tr>
<td>Flipkart Pvt Ltd</td>
<td>E-commerce</td>
<td>IDG ventures, employees and others</td>
<td>Buyback</td>
<td>350</td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>Healthium Medtrach</td>
<td>Healthcare</td>
<td>TPG Growth, CX Partners</td>
<td>Apax Partners</td>
<td>Secondary</td>
<td>298</td>
<td>100%</td>
</tr>
<tr>
<td>SP Infocity, IT Park</td>
<td>Real estate, hospitality and construction</td>
<td>CPPIB and Shapoorji Pallonji Investment Advisors</td>
<td>Temasek</td>
<td>Secondary</td>
<td>282</td>
<td>80%</td>
</tr>
<tr>
<td>ICICI Lombard General Insurance Company Ltd</td>
<td>Financial services</td>
<td>Warburg Pincus</td>
<td>Open market</td>
<td>282</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>E-Infochips Ltd</td>
<td>Technology</td>
<td>GVFL</td>
<td>Arrow Electronics Inc</td>
<td>Strategic</td>
<td>281</td>
<td>100%</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:

- **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.

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68 See footnote 22.
India

a SEBI: India’s capital markets regulator, which regulates all stock market activity. SEBI regulations are applicable when PE firms deal with listed securities.

c CCI: the competition regulator, which is required to pre-approve all PE transactions that fall above the thresholds prescribed in the Competition Act.

d 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 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

Press Note 2 of 2018

The DIPP has released Press Note 2 of 2018, which amends Paragraph 5.2.15.2 of the 2017 FDI policy circular regarding e-commerce activities, and will directly impact revenue and business operations of e-commerce giants (including Amazon and Flipkart) in the following manner:

a An e-commerce entity providing a market place cannot exercise ownership or control over the inventory. If it does do so, it will transform the business into an inventory-based model.

b The inventory of a vendor will be deemed to be controlled by an e-commerce market place entity if more than 25 per cent of purchases of the vendor are from the market place entity or its group companies.

c An entity having either an equity participation or control of its inventory by an e-commerce marketplace entity or its group companies will not be permitted to sell its products on the platform run by the market place entity.

d Services such as logistics, warehousing, advertising or marketing, payments and financing should be provided by e-commerce market place entities or entities in which the e-commerce marketplace entity has direct or indirect equity participation or common control, to vendors on the platform on an arm’s-length basis and in a fair and non-discriminatory manner.

e The cashback provided by the group companies of the marketplace entity to buyers should also be fair and non-discriminatory.

f The e-commerce entity shall not mandate any seller to sell any product exclusively on its platform.

g The e-commerce entity shall furnish, by 30 September of every year, a certificate, along with the statutory auditor’s report to the RBI, confirming compliance with the above-mentioned guidelines for the preceding financial year.

The changes came into force with effect from 1 February 2019. The RBI has issued a notification amending FEMA20R to incorporate Press Note 2 of 2018.

Given that e-commerce entities have been at the forefront of driving big-billion investment bets in India by strategic investors, SWFs and PE/VC players, disruptions in business and loss of revenue arising from the Press Note 2 amendments will dampen the view of investors as regards ease of doing business in India.
**Revamping of external commercial borrowing structure**

The RBI has formulated a new instrument-neutral framework for external commercial borrowings (ECBs) and rupee-denominated bonds to improve the ease of doing business and to strengthen the anti-money laundering and counter-terrorism financing framework. The key changes are as follows:

**a** Merger of tracks: Track I (medium-term ECBs of three to five years) and Track II (long-term ECBs of up to 10 years) have been merged as foreign currency-denominated ECBs. Track III, consisting of NBFCs and microfinance institutions as eligible borrowers, has been merged with rupee-denominated borrowings as Indian rupee-denominated ECBs. Thus, the extant four-tier structure has been replaced by a two-tier structure.

**b** Eligible borrowers: the list of eligible borrowers has been expanded to include all entities that are eligible to receive FDI, including port trusts, units in SEZs, SIDBI, EXIM Bank, registered entities engaged in microfinance activities, societies or trusts or cooperatives; non-governmental organisations can also borrow under the new framework.

**c** Recognised lenders: these have been expanded to include any entity that is a resident of a country that is Financial Action Task Force or International Organisation of Securities Commissions compliant, multilateral and regional financial institutions, and individuals and foreign branches or subsidiaries of Indian banks.

**d** The minimum average maturity period has been kept at three years for all ECBs irrespective of the amount of borrowing, unless the ECB is raised from a foreign equity holder and utilised for working capital, general corporate purposes or repayment of rupee loans for which the maturity period will be five years. Manufacturing companies have been given a special dispensation to raise up to US$50 million per financial year with a maturity period of one year.

**e** ECBs up to US$750 million or equivalent per financial year are permitted under the automatic route.

**Amendment to deposit rules**

The Ministry of Corporate Affairs (MCA) has amended the Companies (Acceptance of Deposits) Rules 2014 to exclude any amount received by a company from REITs, AIFs, domestic VCFs, infrastructure investment funds and mutual funds registered with SEBI from the purview of ‘deposit’ under Rule 2(1)(c)(xviii) of these rules.

**SEBI (Prohibition of Insider Trading) (Amendment) Regulations 2018**

The SEBI (Prohibition of Insider Trading) (Amendment) Regulations 2018 (the Insider Trading Amendment Regulations) will come into effect on 1 April 2019. The Insider Trading Amendment Regulations will have a significant impact on the manner in which listed companies and intermediaries navigate the legal framework for market conduct. The key changes include: (1) the definition of an insider has been widened; (2) immediate relatives will be presumed to be connected persons, with provision for a right to challenge this presumption; (3) the definition of unpublished price-sensitive information (UPSI) has been strengthened by providing a test to identify price-sensitive information, aligning it with listing agreements and providing a platform of disclosure; and (4) the intention to permit access to UPSI though due-diligence processes, with appropriate safeguards (this provision will make it easier for private equity and strategic investors to access UPSI during their due diligence checks), with UPSI having to be disclosed at least two days before trading.
**Long-term capital gains tax**
Exemption from long-term capital gains (LTCG) tax has been disallowed for any income arising from transfer of long-term capital assets, including an equity share in a company or a unit of an equity oriented fund or a unit of a business trust, on or after 1 April 2018. This means that any transfer carried out after 1 April 2018 resulting in LTCG in excess of 100,000 rupees will attract tax at the rate of 10 per cent.

**Revamping of stressed-asset resolution**
On 12 February 2018, the RBI completely refurbished the guidelines on the resolution of stressed assets, including discontinuation of the framework for the joint lender’s forum; the RBI has also withdrawn, with immediate effect, all its existing instructions in relation to the resolution of stressed assets, including the ‘Corporate Debt Restructuring’ and ‘Strategic Debt Restructuring’ schemes and the ‘Scheme for Sustainable Structuring of Stressed Assets’. Under the new framework, the lenders shall formulate a resolution plan as soon as there is a default in a borrower entity’s account with any lender. Strict timelines have been introduced, with low default thresholds, resulting in an increase in cases going under the IBC, as banks and promoters will have limited time to find a sustainable solution. The threat of the IBC will act as a deterrent for all stakeholders to find the right solution within the stipulated time.

**Cross-border merger regulations**
The RBI notified the Foreign Exchange Management (Cross-Border Merger) Regulations, 2018 (the Merger Regulations) on 20 March 2018, permitting both outbound and inbound mergers with foreign companies. The Merger Regulations prohibit any person resident in India from acquiring or transferring any security or debt or asset outside India and any person resident outside India from acquiring or transferring any security or debt or asset in India on account of cross-border mergers, except in accordance with the FEMA, or rules or regulations thereunder or with the general or special permission of the RBI.

**Amendment to SEBI delisting regulations**
Despite global trends, delisting transactions were rarely initiated in India. This is largely because of the prohibitive pricing involved, given that the reverse book building (RBB) process is so susceptible to manipulation. To address some of these concerns, SEBI notified the SEBI (Delisting of Equity Shares) (Second Amendment) Regulations 2018 on 14 November 2018. The aim of the amendment is to plug loopholes in the delisting process considering the interests of the promoters or acquirers and public shareholders by including key changes, such as: (1) inclusion of a provision for the acquirer or promoter to make a counter-offer if the price discovered under the RBB process is not acceptable to the acquirer or promoter; and (2) clarification as to the reference date for computing the floor price.

**SEBI guidelines on fundraising by listed (large) entities from debt markets**
To put into operation the Union budget announcement for 2018–2019 that large corporate entities (LCs) are to be mandated to meet one quarter of their financing needs from the debt market, SEBI has issued detailed guidelines on ‘Fund raising by issuance of Debt Securities by Large Entities’. An LC shall raise not less than 25 per cent of its incremental borrowings, during the financial year subsequent to the financial year in which it is identified as an LC, by way of issuance of debt securities.
Establishment of the National Financial Reporting Authority

The National Financial Reporting Authority (NFRA), an independent regulator for the auditing profession under Section 132 of the Companies Act, has been established. The jurisdiction of the NFRA will extend to listed companies and large unlisted public companies, with predetermined thresholds. The central government may also refer other entities for investigation where public interest is involved. The MCA has also notified the National Financial Reporting Authority Rules 2018.

Master directions on fit-and-proper criteria for sponsors of ARCs

The RBI issued the Fit and Proper Criteria for Sponsors – Asset Reconstruction Companies (Reserve Bank) Directions 2018, which shall apply to existing and proposed sponsors of ARCs. In determining whether the sponsor is fit and proper, the RBI is required to take into account all relevant factors, including the sponsor’s integrity, reputation, track record for compliance with law and for operating a business in a manner consistent with good governance, and similar assessments of individuals and entities associated with the sponsor, sources of funds for acquisitions and the ability to access financial markets, and shareholding agreements and their impact on the control and management of the ARC.

Amendments to the IBC

To make the IBC process more robust and effective, the following key amendments were made to the IBC in 2018:

a. Homebuyers have been recognised as financial creditors, enabling them to invoke Section 7 of the IBC.

b. Promoters of micro, small and medium-sized enterprises are not disqualified from bidding for their enterprises under the corporate insolvency resolution process, unless they are wilful defaulters.

c. An application under the IBC may be withdrawn only with the approval of the committee of creditors with 90 per cent of the voting share, and only before the publication of notice inviting expressions of interest.

d. The voting threshold has been reduced from 75 per cent to 66 per cent for all major decisions. The voting threshold for routine decisions has been reduced to 51 per cent.

V OUTLOOK

It would appear that 2018 was a blockbuster year for deal-making in India, with M&A value exceeding an unprecedented US$100 billion mark. Strong and stable government pushed legal and policy reforms towards ease of doing business in India, reinforcing the belief in India of PE/VC investors, SWFs and deep-pocketed strategic investors. India will be entering 2019 with the benefit of strong tailwinds, and the following factors will have a major impact on investing in India throughout the coming year:

a. General election 2019: markets saw extreme volatility and cautiousness in the final quarter of 2018, which is expected to continue until the conclusion of the general election in the first half of 2019. Transactions are expected to be assessed aggressively with execution possibly being pushed to the second half of 2019. A stable government with a full majority may go a long way in driving up the confidence of investors in Indian markets.
Global environment: uncertainty and volatility triggered by major political events (United States–China trade war, Brexit, meltdown of economies such as Turkey’s), hikes in interest rates by the US Federal Reserve, 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.

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 assets on the auction block.

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 on driving dealmaking activity in India in 2019. Technology, e-commerce, real estate, infrastructure, stressed assets, healthcare, financial services, energy, telecoms and manufacturing are sectors that are expected to continue receiving interest from investors in 2019.

Overall, the deal triggers seen in 2018 are expected to continue to drive both deal values and volumes in 2019.
I OVERVIEW

Deal activity

Based on figures available from Mergermarket in January 2019, overall mergers and acquisitions in 2018 increased by approximately 7 per cent in volume (from 276 to 295 deals) when compared to mergers and acquisitions in 2017. In line with 2017 trends, deal volume in 2018 was above the 10-year average of 231 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. In contrast to deal volume, the aggregate deal value in 2018 was approximately 271 per cent higher than it was in 2017 (from approximately €25.333 billion to €94.073 billion). This significant increase is explained by an exceptionally large deal that took place in 2018, namely the €67 billion acquisition of Shire plc by Takeda Pharmaceutical Company Limited. In line with usual trends, Q2 was a strong quarter for deal activity, with 84 recorded deals; however, deal activity also remained high in Q1 and Q3, with 77 deals and 74 deals respectively. The significant increase in deal value and volume reflects the continued strong recovery in mergers and acquisition activity involving Irish companies. A steady increase in deal volume is expected in 2019.

The Irish Competition and Consumer Protection Commission (CCPC) received 98 merger notifications in 2018, representing an increase of approximately 36 per cent from the 72 mergers notified in 2017. In 2017, the most prominent sectors in terms of a sectoral breakdown of notified mergers were the motor fuel, and information and communications sectors. In contrast, the notifications in 2018 were made most prominently in the real estate and healthcare sectors, although information and communications still featured strongly and mergers in financial and insurance services remained strong. Private equity firms were party to 32 merger notifications made in 2018, representing approximately 33 per cent of the total number of notifications made, largely in line with the percentage in 2017 (31.95 per cent).

The volume of private equity deals increased from 76 in 2017 to 79 in 2018, based on figures available from Mergermarket in January 2019. Deal value (in respect of disclosed consideration for private equity transactions) increased by approximately 69 per cent, from €2.316 billion in 2017 to €3.916 billion in 2018. The figures continue to demonstrate an overall increase in economic activity in Ireland over the past five years. To place this in

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1 David Widger is a partner at A&L Goodbody.
context, the disclosed value of private equity buyouts has increased from €448 million in 2012 to approximately €899 million in 2018, while the disclosed value of private equity exits has increased from €40 million in 2012 to approximately €2.912 billion in 2018.

There were 38 private equity exits during 2018. This is well above the previous year’s figures, with 20 exits in 2017, but it 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 2018 included entities from the United States, France, Canada 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 ratched 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:

a. 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);

b. 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;

c. 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;

d. any employment or service agreements for the senior management of the investee company;

e. 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;

f. share option arrangements; and

g. 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)). As already stated, 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 only 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 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. As previously noted, 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.

**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 judgment 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 company2 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

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2 A company is deemed to be related to another company:

- where it is its holding company or subsidiary;
- where it or its other group companies own more than 50 per cent of the share capital;
- where its own members own more than 50 per cent of the share capital;
- 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;
- where there is another company to which both companies are related; or
- 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.)
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.

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, as mentioned above, 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

As already noted, 2018 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 2019 (in respect of disclosed consideration for private equity transactions), the aggregate private equity deal value (comprising both buyouts and exits) in Ireland in 2018 rose above the 2017 figures by approximately 69 per cent, to €3.916 billion, comprising 79 transactions. Despite deal volume rising above that of 2015 (42 deals), deal value in 2018
still remained below that of 2015, at €13.052 billion (although it should be remembered that 2015 was an exceptional year when compared with previous years; for example, there were 31 transactions worth €7.59 billion in 2014 and 18 transactions worth €448 million in 2012).

The total deals recorded during Q1 in 2018 exceeded the 2017 figures, with 77 deals at an aggregate value of €2.681 billion. Noteworthy deals recorded during the quarter included the acquisition by Circle Internet Financial Limited of Poloniex, LLC, a US-based cryptocurrency exchange platform for an estimated €325 million, the agreement by Experian plc to acquire Clear Score Technology Limited from Blenheim Chalcot Management Limited for €311 million, and Oaktree Capital Management LP’s acquisition of Ireland-based Indego Ltd from the National Asset Management Agency for €250 million.

Deal value (around €73.445 billion) and volume (84 deals) in Q2 were far higher than in the same period in 2017; however, it should be remembered that the considerable increase in deal value in this quarter was due largely to three high-value transactions, namely the acquisition by Takeda Pharmaceutical Company Limited of Shire Plc for a reported value of €67.097 billion (the highest-value M&A deal in 2018), Les Laboratoires Servier SAS’s acquisition of the oncology business of Shire Plc for €1.942 billion, and the agreement by Fidessa to be acquired by ION Investment Group for €1.659 billion.

In Q3 of 2018, a total of 74 deals were recorded, at an aggregate deal value of around €14.994 billion, compared with 64 deals of around €6.831 billion in 2017. Significant transactions recorded during the quarter included Taiyo Nippon Sanso’s agreement to acquire the industrial gas and related machinery and equipment business of Praxair, Inc for €4.913 billion, UPL Corporation Limited’s agreement to acquire Arysta LifeScience Corporation from Platform Specialty Products Corporation for €3.595 billion and ORIX Aviation Systems Limited’s acquisition of a 30 per cent stake in Avolon Holdings Limited for €1.906 billion.

Sixty deals were recorded in the final three months of 2018, with an aggregate deal value of €2.953 billion, representing a decrease in the volume recorded during the same period in 2017. Kerry Group plc’s acquisition of the Fleischmann’s Vinegar Company, Inc for a reported value of €350 million was one of the stand-out deals reported.

### 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. However, in line with the global trend in the past two years, in terms of both deal numbers and proceeds raised, 2018 finished markedly lower than 2016.

A noteworthy transaction in 2018 was the IPO of Iterum Therapeutics plc, an Irish-incorporated biopharmaceutical company, on NASDAQ in May 2018 for approximately $82 million. Iterum is an Irish clinical-stage pharmaceutical company focused
on developing significantly differentiated anti-infectives to treat serious infections resulting from multidrug-resistant bacteria. Pre-IPO, the company was owned by several US-based private equity firms and certain founders.

Another significant transaction in 2018 was the dual listing by Yew Grove REIT plc on the Enterprise Securities Market of the Irish Stock Exchange and the Alternative Investment Market of the London Stock Exchange, raising approximately €75 million. Yew Grove specialises in acquiring, maintaining and letting commercial and industrial properties outside central Dublin.

One 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.

In the property sector, the housing and apartment developer Glenveagh Properties (which took a primary listing on the Irish and London Stock Exchange in October 2017 and raised circa €550 million from investors) raised a further €215 million in July 2018 by way of a share sale.

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.
Key terms of recent control transactions

Takeda/Shire
Japan-based and listed pharmaceuticals company Takeda Pharmaceutical Company Limited agreed to make an offer to acquire Shire Plc, the Irish-headquartered and publicly listed pharmaceuticals company, for €67.097 billion.

Arysta LifeScience Corporation
UPL Corporation Limited agreed to acquire Arysta LifeScience Corporation from Platform Specialty Products Corporation for €3.595 billion.

Praxair Inc
Taiyo Nippon Sanso agreed to acquire the industrial gas and related machinery and equipment business of Praxair, Inc for approximately €4.913 billion, including Praxair’s industrial gas businesses in Belgium, Denmark, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and the United Kingdom.

Exits
As already stated, 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 2018 (based on publicly disclosed deal values on Mergemarket) was approximately €161.777 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.

Clear Score Technology Limited
Experian plc agreed to acquire Clear Score Technology Limited from Blenheim Chalcot Management Limited, Lead Edge Capital Management, LLC and QED Investors LLC for €311 million.

Hilton Dublin Airport Hotel
Westmont Hospitality Group, Inc, a Canada-based owner and operator of hotels, acquired Hilton Dublin Airport Hotel, an Ireland-based company that owns and operates hotels, from Emerald Investment Partners Ltd, a UK-based private equity firm, and Windward Management Limited, an Ireland-based company that operates a chain of hotels and resorts in Europe, for an estimated consideration of approximately €22.5 million.

Novate Medical Limited
BTG plc, a publicly listed UK-based pharmaceutical company acquired Novate Medical Ltd, an Ireland-based medical device company, from Seroba Life Sciences Limited, an Ireland-based venture capital firm, Omnes Capital, a France-based private equity and venture capital firm, ACT Venture Capital Limited, an Ireland-based venture capital firm and Enterprise Ireland, an Ireland-based state development agency, for a cash consideration of approximately €17 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). 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 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 European Union (Anti-Money Laundering: Beneficial Ownership of Corporate Entities) Regulations 2016, transposing the Fourth Anti-Money Laundering Directive into Irish law, came into operation on 15 November 2016. Certain Irish corporate entities must now 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. 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. The Criminal Justice (Money Laundering and Terrorist Financing) (Amendment) Act 2018, fully transposing the Fourth Anti-Money Laundering Directive into Irish law, came into operation on 14 November 2018. It requires designated persons to conduct business risk assessments as part of customer due diligence processes, and they are also required to more comprehensively monitor business relationships. A fifth revision of the Anti-Money Laundering Directive entered into force on 9 July 2018, and must be transposed by Member States by 10 January 2020, while a sixth revision of the Anti-Money Laundering Directive came into effect on 12 November 2018, 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 2017 and 2018 and is likely to continue increasing steadily in 2019. 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 2019.
The recovery of Ireland’s TMT, agri-food, pharmaceutical, and medical and biotech sectors, present 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 three 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 2019, 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 2019.

Although bank funding has increased over the past year and is expected to continue to increase in 2019, international private equity providers are also expected to play an important role in Irish M&A activity in 2019 as they actively seek to take advantage of Irish value opportunities. As mentioned above, it is expected that the purchasers of Irish businesses and assets via distressed debt sales during or immediately following the economic crisis, mainly private equity and hedge funds (a significant proportion of which are US-based), will increase the level of secondary disposals of such assets or debt.

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 2019, 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 three years – financial services, agri-food, TMT and pharmaceutical and life sciences – are likely to continue to do so in 2019.
I OVERVIEW

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 AIFI and PwC 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 million (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.

In the first half-year of 2018, fundraising amounts totalled €1,852 million (as against €1,195 million in the same period in 2017), of which €1,289 million 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 million (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:

- 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;
- 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
- 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 mid-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.

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4 Court of Appeal of Brescia, 8 October 2018, Decision No. 1568.
iii Fiduciary duties and liabilities

Management and coordination of SGRs

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 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 Italian Private Equity Venture Capital and Private Debt Association (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 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;

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5 Court of Milan, 9 January 2018, Decision No. 90.
the SGR and the portfolio companies should adopt management protocols aimed at guaranteeing the autonomy of the target companies;

b 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);
c 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;
d 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
e 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);

6 Deloitte, Italy Private Equity Confidence Survey: Outlook for the first semester 2018.
7 Ibid.
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 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

Private equity deals in 2018 were as active as those in 2017. The total value of transactions in 2017 was a record high at that time, but the total value of transactions in 2018 was even higher because of some very large transactions that year. Bain Capital, together with its co-investors, acquired Toshiba Memory Corporation for approximately US$21 billion, and Kohlberg Kravis Roberts (KKR) purchased Hitachi Kokusai Electric Inc for approximately US$1.7 billion. The recent volume of deals is fuelled by continual active investments related to carve-out deals, involving large companies that wish to focus on their core businesses, and business succession, involving small to medium-sized companies and family-owned companies.

During the period from July 2017 to June 2018, there were four public-to-private deals by private equity funds, including the KKR transaction mentioned above. The number of public-to-private transactions peaked in 2011 with 25 deals in total, and since then the number has decreased and remained low, partly because the high stock price of listed companies for the past five years has discouraged such transactions.

In recent years, there have been approximately 40 to 50 exits each year, and during the period from January 2018 to June 2018, of all the private equity investment exits, trade sales and secondary buy-outs constituted approximately 70 per cent, IPOs constituted approximately 15 per cent, and the remaining 15 per cent consisted of other exits.

Quite a few private equity funds are active in Japan. The funds can be categorised as independent domestic funds, global funds, funds managed by Japanese financial institutions or trading firms, and domestic quasi-governmental funds. The history of funds in Japan started with the independent domestic funds in the late 1990s. Since then, many new funds have emerged every year, but the early independent domestic funds, such as Advantage Partners and Unison Capital, are still very active. As to global funds, many of them, such as Bain Capital, the Carlyle Group, KKR, Permira and CVC, are also active in Japan.

ii Operation of the market

Management equity incentive arrangement

In Japan, it is more common, even in the case of large listed companies, to give only stock options to management, and it is uncommon to prepare a complex equity incentive package for management like those in some other jurisdictions. As to the stock options to be granted to management, although it is technically possible to adopt a complex plan, such
as a performance-based plan, a ‘plain vanilla’ stock option is more commonly provided. It is notable, however, that some of the large listed companies are starting to consider introducing more complex plans reflecting their performance.

The Japanese Tax Code allows a holder of qualified stock options to defer applicable tax, namely qualified stock options are not taxable at the time of exercise of the stock option but become taxable at the time of the disposition of the shares acquired by the exercise of the stock option. The criteria for qualified stock options include:

a. the commencement of an exercisable period no earlier than two years after the resolution to grant stock options, and expiry within 10 years of the resolution;
b. a strike price higher than the price per share at the time of execution of the stock option agreement; and
c. an aggregate strike price exercisable in a single year, not in excess of ¥12 million.

In addition to the stock options, if management have a strong connection with the business (e.g., the founder of the business is part of management), they may be offered an opportunity to hold a minority stake in the acquisition vehicle, which is normally in the range of 5 per cent to 10 per cent, with very limited control over the acquired business but with almost the same level of liquidity as have the sponsors (e.g., by way of tag-along rights).

Sale process

The sale process varies as to whether it is conducted through an auction or not and, if conducted through an auction, how the auction process is conducted. For instance, if the auction process consists of multiple rounds of selection (i.e., a long list for the first-round bid and a short list for the second-round bid), the sale process takes more time. While an auction can increase the possibility of achieving the most favourable deal for the seller, the sale process will likely be at least a few months longer than without an auction.

Apart from the auction process, there are some other factors that can affect the duration of the sale process under Japanese law. Under the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (the Antimonopoly Act), a fund or an investment vehicle must make an advance filing, which requires a 30-day waiting period (though the period can be shortened if the deal is expected to have little or no restrictive effect on competition) if:

a. the aggregate amount of the domestic sales of the purchaser group exceeds ¥20 billion;
b. the aggregate amount of the domestic sales of the target company group exceeds ¥5 billion; and
c. the purchaser acquires more than 20 or 50 per cent of the voting rights of the target company.

Depending on the structure of the fund, the purchaser group may include the portfolio companies of the fund, in which case the domestic sales of the portfolio companies should be included in the domestic sales of the purchaser group.

If the Japan Fair Trade Commission (JFTC) requests the purchaser to submit additional information and materials during the waiting period, the waiting period will be extended until clearance is obtained from the JFTC. Therefore, the closing could be significantly delayed.

In addition, if a fund that falls under the definition of a foreign investor in the Foreign Exchange and Foreign Trade Control Act of Japan (FEFTA) wishes to make an investment in Japan, the fund must submit a notification to the relevant governmental authorities through the Bank of Japan (BOJ) pursuant to the FEFTA. If the target company engages in
certain businesses specified by the FEFTA (such as businesses related to national security and important infrastructure), the purchaser must submit an advance notification, which requires a 30-day waiting period (though the period can be shortened to two weeks if the deal presents no issues in respect of the FEFTA). If the target company is not engaged in the businesses specified by the FEFTA, the FEFTA requires the purchaser to submit a post facto notification to the relevant governmental authorities through the BOJ.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Laws and regulations

When making an investment in Japan, a fund generally needs to take into consideration the Companies Act, the Financial Instruments and Exchange Act (FIEA), the Antimonopoly Act, the FEFTA and, depending on the business segment of the target company, other industry-specific laws. In addition to statutory laws, stock exchange regulations also need to be considered if the transaction involves a listed company.

The Companies Act

The Companies Act provides broad coverage over the issues that will arise from an acquisition of a Japanese company, whether it be by a straightforward acquisition of stock, acquisition of a business or assets or a corporate reorganisation, such as merger or demerger.

The FIEA and the regulations of the relevant stock exchange

These laws and regulations have a significant effect on investments by funds that involve a listed company. For example:

a if a fund seeks to acquire more than one-third of the voting rights of a listed company, the FIEA requires the fund to undertake a tender offer bid (TOB), which is subject to the scrutiny and supervision of the Financial Services Agency and the relevant finance bureau;

b if the transaction involves a listed company, the stock exchange regulations will require the listed company to make a disclosure about the fund; and

c if a fund desires to acquire a substantial amount of newly issued shares from a listed company so that its fully diluted shareholding ratio will be 25 per cent or more or a change of control will occur, the stock exchange regulations will require the listed company to either go through a procedure to confirm approval by its shareholders (usually by a shareholders’ resolution at a general meeting of shareholders) or procure an opinion from an independent person as to the necessity and fairness of the transaction.

The Antimonopoly Act and the FEFTA

The procedures in relation to the Antimonopoly Act and the FEFTA are as discussed in Section I.ii.

Certain industry-specific laws

Depending on the type of business conducted by the target company, a fund’s investment may be subject to industry-specific laws and regulations (e.g., banking and insurance business laws).
**Typical transaction structure**

A typical transaction structure for a buyout by a fund of the shares of a non-listed company is for a special purpose company (SPC), which is newly incorporated as a joint-stock company for the purpose of the acquisition, to (1) receive an equity investment from the fund and financing from lenders, (2) acquire the shares of the target company from the seller, and (3) carry out a merger with the target company with the SPC being the surviving entity, and the fund thereby holding directly the shares of the target company.

A typical transaction structure for a buyout by a fund of a part of the business of a company (i.e., a carve-out transaction) is for an SPC to (1) acquire the shares of a newly incorporated company, which has assumed the target business from the seller through a demerger and (2) carry out a merger with the new company with the SPC being the surviving entity. However, based on tax or other considerations, various other transaction structures may be adopted for a buyout by a fund of a non-listed company or its business.

A typical transaction structure to be adopted for a public-to-private transaction is, in most cases, for an SPC to acquire at least two-thirds of the voting rights of the target through a TOB and to subsequently squeeze out the remaining minority shareholders pursuant to certain technical procedures under the Companies Act using stock consolidation. To accomplish the squeeze-out of minority shareholders, the SPC must secure two-thirds of the voting rights of the target company because this is the threshold required to pass a special resolution at a shareholders’ meeting required for the squeeze-out process. Following an amendment to the Companies Act that came into effect in May 2015, it has become easier to conduct a squeeze-out; for example, a new statutory call option was introduced by the amendment. Under this call option, if the SPC has obtained 90 per cent or more of the voting rights as a result of the first-step TOB, it is able to squeeze out the remaining minority shareholders without a shareholders’ meeting by simply exercising the statutory call option right against those remaining shareholders.

Finally, a cash-out merger was not used for squeeze-outs before 1 October 2017 because it was not tax efficient in most cases. However, as a result of an amendment to the Corporation Tax Act that came into effect on 1 October 2017, a cash-out merger has become more tax efficient when the surviving company holds two-thirds or more of the total issued and outstanding shares of the absorbed company. As such, we expect that the cash-out merger structure may be widely used in the future for the second-step squeeze-out process in a public-to-private transaction sponsored by a fund.

**ii Fiduciary duties and liabilities**

**Directors**

A fund’s portfolio companies overwhelmingly take the form of joint-stock companies. The director of each company appointed by a fund as its representative on the board owes a duty of care and loyalty to the company under the Companies Act. Namely they have a duty to the company to use the due care of a good manager in performing their duties. They must comply with all laws and regulations and the company's articles of incorporation (AOI), as well as all resolutions adopted at general shareholders’ meetings, and perform their duties faithfully for the benefit of the company. Further, based on court precedents, they have a duty to monitor whether the other directors are performing their duties in a lawful and appropriate manner in compliance with applicable laws and regulations and the AOI.

A director is liable to the company for losses of the company caused by his or her negligence in the performance of his or her duties, including a breach of his or her duty of
due care or duty of loyalty. Moreover, if a director causes damage to a third party as a result of his or her wilful misconduct or gross negligence in the performance of his or her duties, the director will be liable to the third party for damages. When examining an alleged breach of the fiduciary duties of a director, Japanese courts follow a rule similar to the business judgement rule in the United States. However, it differs from the US business judgement rule in that courts may examine not only whether an appropriate procedure has been taken but also whether the director’s business decision itself is significantly unreasonable.

**Shareholders**

It is generally understood that a fund that is a shareholder of a company does not owe any fiduciary duty to the other shareholders, even if the fund is the controlling shareholder and there are minority shareholders. Although some scholars are of the view that a controlling shareholder should owe a fiduciary duty to the company and the other shareholders, the Companies Act does not expressly provide for such a duty. Furthermore, to date no court has found there to be a case for such a duty and the above-mentioned view is not the prevailing view in Japan.

Further, in the most commonly used transaction structure where a fund makes an investment through an SPC, the fund is not liable for the buyout undertaken by the SPC, in principle, unless the fund specifically agrees to undertake any liabilities in relation to the seller or the target company pursuant to an agreement with them.

In contrast to the situation where a fund makes an entry investment, a fund usually undertakes various contractual liabilities in relation to the buyer when the fund exits from the investment. A fund may avoid incurring liabilities in relation to the buyer in an exit transaction if the fund arranges the transaction scheme in such a way that only the portfolio company signs the agreement with the buyer as the seller of its business. However, such a transaction scheme is rare, since it is tax-inefficient in most cases. Generally, a fund decides on the transaction structure from the perspective of tax-efficiency and accepts certain contractual liabilities, while trying to include protective provisions in the agreement to limit its liabilities.

**III YEAR IN REVIEW**

**Recent deal activity**

In Japan, details of private equity deals are not disclosed except for certain transactions such as mergers with listed companies and tender offers for the shares of public companies. Even in these exceptional transactions, only the basic terms and conditions are disclosed. Unfortunately, this means little information is available for an analysis of the trends in private equity deal terms and conditions – whereas in certain other countries, such as the United States, listed companies must make more detailed disclosure of any M&A agreements entered into. In addition, as disputes between parties in Japan tend to be resolved through mutual negotiation, there is a dearth of case law regarding agreements related to private equity deals.

There was, however, an important Supreme Court decision in July 2016 for the shares of Jupiter Telecommunications Co, Ltd with respect to a tender offer followed by a squeeze-out transaction (the JCOM decision). Under Japanese law, a minority shareholder who opposes a squeeze-out has an appraisal right to request the court to determine the price to be paid to the minority shareholder as a result of the squeeze-out process (the squeeze-out price). Generally, in past similar litigation, while the company claimed that the squeeze-out
price should be the same as the tender offer price, the courts decided that the squeeze-out price should be the objective price (which means the market price immediately prior to the disclosure of the tender offer subject to a certain adjustment based on regression analysis for the time difference between the tender offer and the squeeze-out process – an adjustment mechanism adopted by some recent lower court cases based on economic analysis) plus certain premiums (approximately 15 to 25 per cent). The JCOM decision, however, stated that even in a conflict-of-interest situation, such as an acquisition of the target company by the parent company as in this case, as long as the tender offer was conducted under a fair and generally accepted procedure, such as seeking opinions from an independent committee and professionals, the squeeze-out price should be the same as the tender offer price unless there exist special circumstances where the fundamental facts underlying the transaction have unexpectedly changed. It is generally understood that the framework of the JCOM decision will also apply to the determination of the squeeze-out price in squeeze-out transactions between parties who are not in a conflict-of-interest situation, such as an acquisition of a listed target by a fund. As such, since the JCOM decision, the squeeze-out process has become more stable for acquirers.

ii Financing

Recent trends

Since the spreads in general corporate loans have tended to be set low in Japan, in 2018 Japanese lenders continued to be active in providing acquisition finance, which is attractive to them because of the generally higher spreads. A new development is that, as Japanese companies’ interest shifts to outbound acquisitions, in response to a shrinking domestic market (which is, in turn, due to a declining and ageing population), Japanese lenders are becoming more active in providing financing for cross-border acquisitions. This has been considered more challenging because of the legal, operational and other difficulties arising out of the cross-border context, such as creating security packages in other jurisdictions. In addition, new types of acquisition financing such as recapitalisation transaction, share financing, ‘holdco’ financing and subscription financings are growing steadily. These trends will continue in the coming years.

Types of acquisition financing and sources of finance

Usually only senior loans as syndicated loans are used for acquisition financing. As senior lenders, Japanese commercial banks, trust banks and government-related banks play important roles. In particular, the Japanese acquisition finance market is dominated by Japan’s three mega banks (i.e., MUFG Bank, Sumitomo Mitsui Banking Corporation and Mizuho Bank).

However, if the size of a deal is large, or the leverage of the deal is high, mezzanine finance is additionally used. As mezzanine financiers, certain mezzanine funds established by banks, insurance companies or securities companies or independent mezzanine funds, bank subsidiaries and lease companies play important roles. Mezzanine financing is typically provided by way of non-voting preferred shares or subordinated loans. An equity kicker in the form of warrants is added to subordinated loans from time to time. A high-yield debt market has not yet developed in Japan.
Key financial and legal terms

Senior loans usually consist of term loan A, term loan B and a revolving loan. Term loan A is fully amortised while term loan B is paid at maturity in a lump sum. Term loan A and term loan B are used to finance the closing of the acquisition, refinancing of the existing indebtedness and the transaction costs. The revolving loan is used to finance working capital. The term of each tranche is typically five to seven years. Financial covenants typically include a leverage ratio, debt service coverage ratio, minimum net worth, positive income and maximum CAPEX. An unusual feature of the Japanese syndication market is that typically investors participate in all tranches on a pro rata basis, although this may change in the future.

The preferred shares used for mezzanine financing are usually non-voting, cumulative and non-participating shares because the intention of mezzanine investors is to secure the agreed return. In addition, to secure the mezzanine financier’s position, conversion rights to the voting shares are usually attached to the preferred shares so that the financier can exercise the conversion right and seize control of the company in event of the company’s financial distress. In addition, it is common for redemption rights to be granted to the mezzanine financier to secure its exit. Since payment of dividends to preferred shareholders is not permitted under a typical senior loan agreement until the company repays the senior loan in full, the mezzanine financier, as a preferred shareholder, is contractually subordinated to the senior lenders.

The subordinate nature of the subordinated loans used for mezzanine financing is also contractually created through an inter-creditor agreement among senior lenders, mezzanine financiers and the borrower.

Senior loans and subordinated loans are secured by a security package that basically covers all assets of the borrower and the target company.

iii Key terms of recent control transactions

Price adjustment

Traditionally, it has been more common, especially in domestic transactions, for price adjustment mechanisms not to be included in stock purchase agreements for the sale of non-listed companies. In such transactions, the seller usually has an obligation to have the target company conduct its business in the ordinary course of business, but any specific provision to avoid leakage to the sellers or their related persons, such as the ‘locked-box mechanism’, remains uncommon, although this may change in the future.

On the other hand, purchase price adjustment mechanisms are frequently used, especially in the case of large volume deals or deals in which the period between the execution of the definitive agreement and closing is expected to be lengthy for various reasons, such as the antitrust clearance process. In such cases, a closing account is prepared and, typically, the difference between the normalised working capital peg agreed to in the definitive agreement and the actual working capital amount as at the closing date is subject to a dollar-to-dollar adjustment, either upwards or downwards. Recently, however, especially in the auction process, the seller often requires that no price adjustment mechanism be included in bidders’ submissions.

Representation and warranty insurance

While representation and warranty insurance is available in Japan, its use is limited and it is still rare to see actual issuances of representation and warranty insurance for domestic
transactions. This is probably because it is still not very common in Japan for a party to make a claim for indemnity based on the definitive agreement. Accordingly, given the time and cost of taking out the insurance, its merits are not fully appreciated by M&A players in Japan. However, representation and warranty insurance is receiving more attention, and the time and cost of taking out the insurance is expected to decrease because of the efforts of insurance companies. In addition, especially in the case where a private equity fund is the seller, use of representation and warranty insurance will reduce the residual risk after the closing and provide for a clean exit. As such, the use of representation and warranty insurance may gradually increase in the future.

**Reverse break-up fee**

It is rare that a reverse break-up fee clause is provided in a definitive agreement in Japan. In Japan, instances of unsuccessful closings due to a failure to satisfy conditions precedent, including financing failures, are scarce. In addition, disputes in which a party seeks liability for an unsuccessful closing are very rare, and it is unlikely that a Japanese court ruling will apportion significant liability in the case of an unsuccessful closing. Accordingly, the parties do not have much incentive to negotiate reverse break-up fees. However, especially in cross-border transactions, there exists an increasing risk that an antitrust clearing cannot be obtained in one or more of the relevant jurisdictions where the subsidiaries of the target company are located, so use of reverse break-up fees may increase in the future in this area to share the risks associated with antitrust filings.

**Finance out**

In a trade sale of the shares of a non-listed company, whether a finance-out clause is included depends on the outcome of the negotiation of the parties. On the other hand, as explained above, in the case of a listed target, a tender offer is mandatory for a fund to obtain control of the target. Under the FIEA, triggering events that allow a tender offeror to withdraw a tender offer after it has been launched are very restricted and exhaustively listed. In particular, neither a failure of financing nor the occurrence of a material adverse change (MAC) is listed as such a triggering event. In other words, a fund may employ neither a finance-out nor a MAC-out mechanism in the case of an acquisition of a listed target. However, bank commitment letters usually provide many conditions precedent to extending loans, including a business MAC and a market MAC. Accordingly, even if the lenders withdraw from the financing for the tender offer because of a MAC event, the fund must still close the tender offer by raising the necessary funds from other financing sources, including equity, or it will default. However, to date no default cases due to a financing failure of this nature have occurred in Japan.

iv  Exits

For the past few years, 40 to 50 exits have occurred annually. Approximately 70–80 per cent of exits are achieved by way of a trade sale including a secondary buyout. During the period from July 2017 to June 2018, 10 initial public offerings were launched. The average period between the entry and the exit is approximately five years.

IV  REGULATORY DEVELOPMENTS

Other than fundraising and fund management, there is no regulatory body that is specifically charged with overseeing PE transactions or PE sponsors’ activities unless the PE sponsors
conduct activities that fall within the scope of a financial instruments business as defined in the FIEA, such as an investment advisory business, which is not common. However, as explained in Section II, various regulations may apply to each PE transaction or to PE sponsors’ activities.

V  OUTLOOK

It is expected that the general trends described in Section I will continue in 2019. The overwhelming majority of deals in 2019 will be mid- to small-cap transactions, while there could be some mega deals. Investments involving the business succession of small to medium-sized companies will continue to be very active.
I OVERVIEW

Deal activity

Offshore private equity funds (foreign PEFs) became active in Korea during the immediate aftermath of the Asian financial crisis of 1997; this period saw an influx of foreign investment to buy Korean companies, thus forming Korea's M&A market landscape as it is today. Following the entry of foreign PEFs into the Korean M&A market, the 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 Financial Investment Services and Capital Markets Act of 2007 (the Capital Markets Act). From then on, Korean PEFs, whether sponsored by independent private equity houses, securities firms or other financial institutions, have been active players in the Korean M&A market. As at June 2018, there were a total of 501 Korean PEFs registered in Korea with a total commitment amount of 66.4 trillion won, and the competition among Korean and foreign PEFs continues to heat up.

In 2018, there were 449 M&A transactions in terms of volume, with total deal value amounting to US$53.1 billion; these figures represent a substantial increase compared to 2017, for which, in terms of volume, 360 deals were recorded, worth US$41.6 billion in terms of total deal value. 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.

In 2017, M&A transactions in Korea decreased by 23.2 per cent in terms of value compared to 2016, for which, in terms of volume, 352 deals were recorded, amounting to US$46.8 billion in value. On the basis of deal value, the consumer goods sector was the most popular target industry in 2018, with 57 deals, worth US$10.4 billion in terms of deal

1 Chris Chang-Hyun Song, Tong-Gun Lee, Brandon Ryu, Joon Hyug Chung are partners and Alex Kim and Sung Uk Bak are associates at Shin & Kim.


3 Mergermarket, South Korea M&A activity, Q1–Q3 2018 trend report.

4 Mergermarket, South Korea M&A activity, Q1–Q4 2017 trend report.
value. The industrials and chemicals sector was the second most active sector in 2017 by deal value, with 103 transactions worth US$9.6 billion, but this was a 45.6 per cent decrease in value compared to 2016, for which 104 deals were recorded, worth US$17.7 billion in value. The financial services sector followed with 26 deals, worth US$7.3 billion, representing a 40.5 per cent drop in terms of value compared to 2016, for which 25 deals were recorded, worth US$12.3 billion in value. The year 2017 saw 42 inbound deals, worth US$7.3 billion in value, a 79 per cent increase in value compared to the 46 inbound deals in 2016, which were worth US$4.1 billion in value. In terms of nationality, investors from the United Kingdom were the most represented, with two deals worth a total of US$2.6 billion in value, followed by US-based investors with 12 deals worth US$2 billion in value, and investors from Greater China with 10 deals worth US$1.3 billion in value. Investment from mainland China has decreased from US$1 billion in 2016 to US$512 million in 2017, partly because of geopolitical issues; however, a meeting between the Korean and Chinese heads of state took place in December 2017, which could have positive effects in alleviating political tensions and resulting in more M&A activity in Korea by Chinese investors.

After hitting historical highs in 2015, there was a downturn in Korean M&A transactions during 2016. The year 2016 saw 352 deals worth US$46.8 billion, which was a 44.8 per cent decrease in value compared to 2015.5 In 2015, there were 362 deals worth US$87.5 billion, which was a 13.6 per cent increase in value compared to 2014, making 2015 the peak year in terms of both deal volume and value.6 The year 2014 had 334 deals worth US$73.5 billion, which represented a 107 per cent increase in value compared to 2013.7 In 2013, there were 274 deals worth US$36.1 billion, which represented a 22.5 per cent increase in value compared to 2012.8

### Private equity funds activity

In 2018, there were 91 acquisition deals worth US$7.7 billion in value sponsored by PEFs. With respect to exit deals by PEFs, 2018 saw a 59.20 per cent increase in value, with 36 deals worth US$10.03 billion compared to 27 deals in 2017, worth US$6.3 billion (excluding initial public offerings (IPOs)).

The table below shows the annual aggregate deal volume and deal count for acquisitions and exits by PEFs from 2007 to 2017.

<table>
<thead>
<tr>
<th>Year</th>
<th>Acquisitions</th>
<th></th>
<th>Exits (excluding IPOs)</th>
<th></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>2018</td>
<td>7.70</td>
<td>91</td>
<td>10.03</td>
<td>36</td>
</tr>
<tr>
<td>2017</td>
<td>10.03</td>
<td>91</td>
<td>6.35</td>
<td>28</td>
</tr>
<tr>
<td>2007</td>
<td>4.86</td>
<td>13</td>
<td>4.33</td>
<td>17</td>
</tr>
</tbody>
</table>

5 Mergermarket, South Korea M&A activity, Q1–Q4 2016 trend report.
6 Mergermarket, South Korea M&A activity, Q1–Q4 2015 trend report.
7 Mergermarket, South Korea M&A activity, 2014 trend report.
8 Mergermarket, South Korea M&A activity, 2013 trend report.
9 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 a special purpose vehicle.
With respect to acquisition deals by PEFs in 2018, there were 18 acquisitions with value exceeding US$100 million; this was a decrease from 2017, which had 25 acquisitions exceeding US$100 million. Among these 18 acquisition deals, there was one deal with value equal to US$1 billion or more, and two deals with value between US$100 million and US$500 million. With respect to exit deals by PEFs in 2018, there were 12 deals with value equal to US$100 million or more, which was an increase from 2017, which had only five exit deals with value exceeding US$100 million. Among the 12 exit deals in 2018, there was one deal with value equal to US$1 billion or more.

The following table compares the annual aggregate number of deals by PEFs in terms of value from 2007 to 2018.

<table>
<thead>
<tr>
<th>Year</th>
<th>Acquisitions</th>
<th>Exits (excluding IPOs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US$1 billion or over</td>
<td>US$500 million or over</td>
</tr>
<tr>
<td>2018</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>2017</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>2007</td>
<td>1</td>
<td>3</td>
</tr>
</tbody>
</table>

Buyout and majority stake deals decreased by 39.13 per cent in 2018 compared with 2017 in terms of deal value, while deal volume increased to 28 from 21. In 2018, minority stake acquisition deals decreased in terms of deal value by 45.68 per cent to US$1.89 billion from US$3.48 billion in 2017, and deal volume also decreased from 27 in 2017 to 16 in 2018.\(^\text{10}\)

<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>2018</td>
<td>-</td>
<td>-</td>
<td>1.26</td>
<td>28</td>
</tr>
<tr>
<td>2017</td>
<td>-</td>
<td>-</td>
<td>2.07</td>
<td>21</td>
</tr>
<tr>
<td>2007</td>
<td>0.21</td>
<td>3</td>
<td>1.91</td>
<td>1</td>
</tr>
</tbody>
</table>

There were no public-to-private deals in 2018, compared to the single public-to-private transaction in 2017 worth US$0.36 billion. In general, public-to-private deals are not common in Korea, with only four public-to-private transactions recorded from 2007 to 2018.

In 2018, trade sales deals increased in terms of deal value to US$8.91 billion compared to US$4.20 billion in 2017; likewise, deal volume also increased to 28 in 2018 compared to 21 deals in 2017. Secondary sales deals among PEFs decreased in terms of deal value in 2018, with deal value at US$1.12 billion compared to US$2.15 billion in 2017; deal volume increased in 2018 to eight deals from seven deals in 2017. Finally, IPO deals decreased in terms of deal value in 2018, with deal value at US$0.17 billion compared to US$0.53 billion in 2017; deal volume for IPOs also decreased, from 16 deals in 2017 to seven deals in 2018.

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\(^\text{10}\) The data in the above table is based solely on the deal information disclosed in the Mergermarket survey. Figures concerning acquired stakes were mostly undisclosed.
Korea

<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>2018</td>
<td>8.91</td>
<td>28</td>
<td>1.12</td>
</tr>
<tr>
<td>2017</td>
<td>4.20</td>
<td>21</td>
<td>2.15</td>
</tr>
<tr>
<td>2007</td>
<td>3.07</td>
<td>11</td>
<td>1.24</td>
</tr>
</tbody>
</table>

Registered private equity funds

Typical buyout-type PEFs were introduced to Korea in 2004 under the Indirect Investment Asset Management Business Act; as at June 2018, a total of 501 PEFs were registered with the Financial Supervisory Service (FSS). In 2017, there was a significant increase of 135 newly registered PEFs, while there were 57 newly registered PEFs in 2018. The total commitment amount also increased from 62.6 trillion won in 2017 to 66.4 trillion won in 2018.

Registered general partners of private equity funds

As at December 2017, a total of 209 general partners (GPs) are registered with the FSS; among these 209 GPs, 138 are full-time GPs. The remaining 71 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 23 in 2016 to 19 in 2017; on the other hand, the number of full-time GPs newly registered with the FSS increased from 21 in 2016 to 23 in 2017. Note that, as at January 2019, the FSS has yet to disclose the number of registered GPs of private equity funds for 2018.

The largest private equity funds set up by major GPs in Korea in terms of committed capital are as follows: a US$2.44 billion fund set up by the Korea Development Bank called KDB Value VI Fund; a US$2.26 billion fund set up by MBK Partners called MBK III; a US$1.24 billion fund set up by UAMCO called United PF 1st Corporate Finance Stability; and a US$1.23 billion fund set up by Hahn & Company called Hahn & Company II-1.

11 The vast majority of these were registered under Capital Markets Act, but the total number includes those registered under the Industrial Development Act and Overseas Resources Development Business Act.
ii Operation of the market

Standard sales process

As is the case in other jurisdictions, the investment process for private equity funds in 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. 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 Korean M&A deals.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Pursuant to the Capital Markets Act, 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 Capital Markets Act, and thus Korean PEFs has been pressing for regulatory change to secure a level playing field between Korean PEFs and foreign PEFs.

ii 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.

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12 As an exception, a majority shareholder holding 51 per cent or more of a company's total issued shares can be subject to secondary tax liability; also, if a majority shareholder is deemed to have pierced the corporate veil, the shareholder will also be subject to shareholder liability.
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 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

i Recent deal activity

The year 2018 saw a diverse range of M&A deals in 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, Apollo’s sale of Momentive Performance Materials to the KCC, Wonik, QNC and SJL Partners consortium, had a deal value of approximately US$3.5 billion. In addition, the Carlyle Group sold its 100 per cent stake in Siren Holdings, a company engaged in security solutions business, via its subsidiary ADT Caps to the SK Telecom, Daishin PE and Keistone Partners consortium with a value of approximately US$2.7 billion. MBK Partners made two successful exits by selling its 59.15 per cent stake in Orange Life Insurance to Shinhan Finance Group, with a deal value of approximately US$2.2 billion, and selling its 22.17 per cent stake in Coway to Woongjin ThinkBig with a deal value of approximately US$1.6 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 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 Hanwha 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.
Financing
As mentioned above, 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 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. In the event 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.

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 sometime 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.

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

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13 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.

14 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.

15 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.
before interest, tax, depreciation and amortisation; business profits, net profits, cash flow, turnover, etc. In 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 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
The Capital Markets Act requires all Korean PEFs to be registered with the FSS. Furthermore, as stated above, 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 private equity fund 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, up from 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. On 17 December 2018, the government announced that the One-Shot Law would remain in effect until August 2024 and that its scope would be expanded to include ‘Fourth Industrial Revolution’ (or 4IR) businesses and also companies located in industrial crisis zones.

The M&A landscape in 2019 will depend on the regulatory reform efforts of the Korean government and geopolitical factors such as Korea's relation with neighbouring countries and denuclearisation of North Korea.

V OUTLOOK

After hitting historic peaks in 2014 and 2015, the Korean M&A market saw a temporary slowdown in the past few years; however, this downward trend is once again being reversed, with the 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 preemptive restructuring attempts by Korean companies, and the ongoing development of PEFs means there is cautious optimism that the Korean M&A market will continue to expand in 2019.

In terms of challenges in 2019, PEFs will have to grapple with the worsening economic situation in 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 2019; furthermore, key industries such as automobiles and semiconductors are showing signs of slowing down, while the global economic slump is also projected to impact Korea’s M&A market in 2019. Nonetheless, there are various factors to offset these negative influences, including the preemptive restructuring of various 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 deal-making potential for both Korean and foreign PEFs in 2019.
Chapter 12

LUXEMBOURG

Frank Mausen, Patrick Mischo, Peter Myners and Jean-Christian Six

I

OVERVIEW

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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, encompassing 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; for example, 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

1 Frank Mausen, Patrick Mischo, Peter Myners and Jean-Christian Six are partners at Allen & Overy.
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 IRR performance. There are some Luxembourg law constraints (for example, 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 an SCA (partnership limited by shares) or 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 limited partnership (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 SPAs 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 was the new Companies Act in 2016 and its ‘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 KYC 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), 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 Law) was passed by the Luxembourg parliament on 18 December 2018. Most of the provisions of the Law apply as from 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 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

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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.
of the taxpayer’s earnings before interest, taxes, depreciation and amortisation (EBITDA). 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 of the European Parliament and of the Council of 12 December 2017, 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 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 Law also implements into Luxembourg domestic law an anti-hybrid rule, as provided under ATAD 1. This anti-hybrid rule targets 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 covers hybrid mismatches in a pure EU context. The rule would, in particular, apply in a situation in which a Luxembourg company would be invested into through a tax-transparent fund by EU resident investors holding an interest of more than 25% per cent in the Luxembourg company. The anti-hybrid rule under ATAD 1 was subsequently amended in 2017 by Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (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. Most of the ATAD 2 provisions will have to be implemented into different domestic laws before 1 January 2020. The Luxembourg legislature has only implemented into Luxembourg domestic law the initial anti-hybrid rule under ATAD 1. This means that a second bill of law is expected for 2019, as Luxembourg will have to implement into Luxembourg domestic law the anti-hybrid provisions under ATAD 2 by the end of this year.

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 is very competent and most high-yield debt securities are either listed on the regulated market or on the Euro MTF of the Luxembourg Stock Exchange. Recently, the Luxembourg Stock Exchange 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 Luxembourg Stock Exchange. 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.

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 to 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.
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 a way to lose 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 is the steady growth of gross domestic product (GDP), which increased at an annual rate of approximately 2.5 per cent between 2013 and 2018, and the several pro-growth aggressive 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 comparator), 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, to 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 both in the opening up of the energy sector to private investment (with committed investments having now reached US$175 billion in this sector, according to the OECD) and in the creation of public funds to encourage the development of small and medium-sized companies. However, one of the primary challenges facing private
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.

For example, fundraising activities have been increasing since 2007. Between 2007 and 2017, the number of private equity funds in Mexico increased from 41 to 177, and the capital invested increased from US$11 billion to US$51 billion. This represents an annual growth of 10 per cent in the private equity industry. 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 been 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 even 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 been the subject of considerable growing interest. Following publication of the Fintech Law and the first round 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 continuing to grow, 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:

- capital contributions from partners or shareholders;
- government financing;
- private equity;
- project finance;
- financing by banking institutions; and
- 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:

- growth, through investing in companies looking for expansion, entering new markets or financing strategic acquisitions;
- leveraged buyouts, namely specialising in acquiring companies via external capital;
- mezzanine capital, which allows for more flexibility as fewer guarantees are required (meaning more risk and higher costs); or
- 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 before, 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 express 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 previous steps and the investment is effectively done, 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 the above-mentioned goals, and in the whole process, is obviously that the fund must be 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, who 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 566,900 million Mexican pesos, which represents 2.4 per cent of Mexico’s GDP for productive and infrastructure activities.

As detailed above 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 (similar to the Mexican sociedad comandita por acciones);
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 making clear the limitations applicable to foreigners. According to the Foreign Investment Law, foreigners are subject to certain limitations as to their ownership and control of, and participation in, the companies and sectors in which they can invest (usually related to national security). There are also certain sectors in which they cannot invest at all, as they are exclusively reserved for Mexicans: for
example, the national transportation of passengers, tourism, loading, 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 in fact
imply very few, and specific, restrictions. As previously mentioned, the legal regime has
been created with the specific intent of facilitating foreign investment into 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 effective the investment.

There are several crucial elements in every relationship that may give rise to complaints
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 IPO,
a secondary deal (acquisition, sale), repurchase by the promoters or, in 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 there being some tax considerations, Mexico
is a fairly straightforward and dynamic country in which to invest and disinvest.

III YEAR IN REVIEW

According to the Latin American Private Equity & Venture Capital Association (LAVCA),
KKR, a subsidiary of Kohlberg Kravis Roberts & Co, a global private equity and venture
capital fund, listed a US$500 million CERPI on the Mexican stock exchange to invest in
private equity, energy and infrastructure projects.

Fortem Capital, a Mexican real estate fund, placed a CKD vehicle for up to 5 billion
pesos on the Mexican stock exchange, and plans to use the capital to develop between 13 and
16 projects in the retail, residential and health sectors.
Private equity fund Fondo de Fondos listed a CKD on the Mexican stock exchange, with a view to investing in private equity funds and projects that target the infrastructure and renewable energy sectors.²

Grupo O’Donnell registered a CKD with a maximum issuance of 2 billion pesos on the Mexican stock exchange, aimed at industrial and urban real estate, and the development of industrial logistics infrastructure.³

BlackRock Mexico Infraestructura III raised a US$500 million CERPI on the Mexican stock exchange for investments in energy, transportation, water and social infrastructure projects.

Avant Energy, a Mexican company backed by US private equity firm Riverstone Holdings, announced it will increase its previous investment in the SUPERA project, a network of terminals to supply refined petroleum products in north-central Mexico, from US$200 million to US$500 million.

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 2018 focused principally on energy, e-commerce, telecommunications and financial services. However, as previously mentioned, two more sectors are now gaining more 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.

i Financing

Private equity activity in Mexico is increasing significantly as a result of several financial reforms that have taken place 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 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.

ii Key terms of recent control transactions
In January 2018, Adobe Capital’s Mezzanine Fund II announced its first impact investment in
Instituto Profesional en Terapias y Humanidades (IPETH), a Mexican enterprise specialising
in physiotherapy and offering quality higher education to low-to-medium-income students.
Adobe Capital’s investment, made together with Auria Capital, continues its innovative
approach to mezzanine instruments and is intended to support IPETH’s national expansion
and maximise the education company’s contribution to improving health and education
in Mexico.4

In March 2018, Latin American Partners LLC (LAP), a private fund manager,
and IGNIA, a venture capital fund manager, announced the completion of a mezzanine
investment by the Central American Mezzanine Infrastructure Fund (CAMIF II) in
Procesamiento Especializado de Alimentos SAPI de CV (Grupo Procesa), a vertically
integrated tuna producer and market leader in its main segment. As part of the transaction,
MANIF II acquired IGNIA’s entire participation in Grupo Procesa. LAP acts as the CAMIF II
fund manager.5

In November 2018, Discovery Americas, through its investment vehicle DAIV,
invested in Mas Air, a leading participant in the Mexican cargo industry, and consequently
the LATAM Airlines Group is no longer a shareholder of Mas Air.

iii Exits
During Q1 2018, there were several exits of note in the Mexican private equity market. In
February 2018, Nexxus Capital completed a partial exit from Mexican real estate developer
and operator Grupo Desarrollador ZKC, 27 months after its initial investment and a return
of 45 per cent. In the same month, Nexxus Capital announced another partial exit, this time
from Maak Arca Holding, SAPI de CV (Maak) a consolidating platform for the acquisition
and operation of businesses within the construction and decoration industries in Mexico.
This exit was made through the spin-off and sale of Maak’s subsidiaries Marmoles Arca SA de
CV and Madarca SA de CV.

In March 2018, Mexican.VC announced a partial exit from Yogome, a Mexican edtech
start-up creating videogames for children, making an eight-times cash-on-cash return to
the fund.

In December 2018, Riverstone Holdings, ENCAP Investments and BlackRock exited
Sierra Oil & Gas, a Mexican exploration and production company, in a sale to Deutsche
Erdoel AG, an international independent exploration and production company.

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.

In October 2016, the Fibra E vehicle Fibra Vía 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 pesos, with the first issue raising 800 million pesos.

While CerPIs and Fibra E vehicles have not yet been widely used, these instruments have consistently gained 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 allowing 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 in Mexico has steadily become a more competitive sector for investment in the country. 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 potential for uncertainty over the past months as a result of the North American Free Trade Agreement negotiations and the presidential election, the outlook for the Mexican private equity industry is positive. Over the next year, investments in the energy and telecoms sectors are expected to continue to increase and the fintech industry is set to become a hotspot for national and foreign investments; an increase in the use of the recently developed financing instruments, CKDs, CerPIs and Fibra E vehicles, is also anticipated, combined with greater participation by private equity sponsors. There is a lot of expectation for the country's private equity market over the next few years, given the tendency in government policies for a shift towards a larger role for private investment in the industries and sectors discussed here. According to AMEXCAP, should conditions remain as they are at present, with growth remaining at current levels, private equity in Mexico is expected to have raised over US$80 billion by the end of 2020.
NORWAY

Chapter 14

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, with severely reduced investment activity, lay-offs of personnel and debt restructuring in the oil-related sectors that have only recently shown signs of abating and reversal. The oil price has since remained both relatively low and volatile.

These developments in the Norwegian economy affect private equity investors active in the Norwegian market, as they do other investors. The most direct consequence of the reduction in oil prices has been that sellers have proved hesitant to make sales based on the reduced prices. Correspondingly, buyers have been generally unwilling to make purchases based on the older higher prices. 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 kroner to 8.5 billion kroner in 2017. There were no public-to-private deals (of any significance) in 2017.\(^4\)

The number of private equity exits by funds advised by Norwegian sponsors continued its downward trend from 43 in 2016 (and 43 in 2015) to 39 in 2016.\(^5\)

In 2017, no private equity exits were made in the form of an initial public offering (IPO) in 2017. In 2018, however, government-backed venture investor Investinor (see below) partially exited poLight through an IPO. 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

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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.
exit route as previously in the Norwegian market, except in exceptional cases. Oslo Børs is currently the target of a possible acquisition, which may change the future attractiveness of that market place.

As at the start of 2019, a total of 147 Norwegian alternative investment fund managers were registered or authorised by the Financial Supervisory Authority of Norway, compared to 125 the year before. Approximately half are private equity managers. The exact number of alternative investment funds established in Norway is unclear, as many private equity funds will 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).

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 or Hadean, the first two focusing on technology and assets connected to the exploration of oil and gas, and the latter a healthcare specialist. Third, there are a number of smaller sponsors in the venture and seed capital segments, such as Proventure, Verdane 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. Notable examples are the 2017 acquisition of the Norwegian software company Visma by HgCapital, Montagu Private Equity and other partners, the Triton Partners acquisition of a 75.15 per cent stake in Glamox AS, and the acquisition of Norsk Gjenvinning by Swedish Summa Equity.

A 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 of Q3 2018, the investment portfolio of Investinor AS amounted to 2.2 billion kroner (unchanged from the year before). Investinor has financial assets and a commitment from the government amounting to 4.2 billion kroner, as well as an undrawn government commitment of 1.25 billion kroner.6

There were a few new fund sponsors in Norway in 2017 and 2018, such as healthcare specialist Hadean Ventures, mid-cap Explore Equity and Serendipity Partners.

ii 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 2018 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 (see) 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-competition 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. As mentioned above, 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 Directive7 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 Directive8 through

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7 Directive 2004/25/EC.
8 Directive 2004/109/EC.
rules in the 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 2019.

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). 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 kroner or more, and at least two of the undertakings concerned each has an annual turnover exceeding 100 million kroner. An automatic standstill period, ending at the earliest 25 working days after a filing has been made, applies to all concentrations subject to the notification requirement. 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 also be aware that the Norwegian Private Limited Company Act and Public Limited Company Act contain specific provisions concerning the payment of dividend and of financial assistance to other group companies. The Ministry of Justice has carried out a consultation process, proposing to introduce greater flexibility concerning financial assistance for limited companies. This would require amending the relevant company acts, which has yet to be formally proposed. It is uncertain when these changes may enter into effect.

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 company has been under-capitalised compared to the financial risk involved in its operations.

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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). As mentioned 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 kroner invested by funds advised by Norwegian sponsors, led by investments in the buyout segment, the figure declined to 8.5 billion kroner in 2017.\(^{11}\) Preliminary figures suggest that the number is slightly lower for 2018, with generally lower-value (but more) deals.\(^{12}\)

There were few large transactions made by Norwegian private equity sponsors. A notable exception was the merger of Italian energy company Eni’s Norwegian operation and HitecVision-owned petroleum company Point Resources (itself a product of the merger of Core Energy, Spike Exploration and Pure E&P), creating Vår Energi.

The long-term trend is for transactions that are largely Nordic-centric, with Nordic private equity sponsors typically investing in the Nordic countries, followed by US and UK

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\(^{11}\) NVCA, Private Equity Funds in Norway – Activity Report 2016.

\(^{12}\) Mergermarket, BAHR AS internal study.
actors. The telecoms, business services and petroleum sectors dominate transactions overall. During 2018, a number of retail chains began facing financial difficulties. For a period following the fall in oil prices, retail was also an attractive sector for private equity investors. It remains to be seen whether this will force consolidations or other transactions in the sector.

### 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

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 and 39 in 2016 and 2017 respectively.¹³ On the basis of preliminary data, it seems this trend has continued into 2018.¹⁴

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¹⁴ Argentum market report H1 2018, Q3 2018.

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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 large number of managers are, however, 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.

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),15 the EU Regulation on social entrepreneurship funds (EuSEF),16 and delegated regulation under the EU Regulation on long-term investment funds (ELTIF).17

As mentioned above, 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 consultation period was relatively short, suggesting that the Ministry of Finance may prioritise implementation in 2019. This will 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

Norwithstanding 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), and also environmental, social and governance 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). Further, while Norway has implemented the Capital Requirements Directive IV, the SME supporting factor – providing for a lower capital charge for exposure towards SMEs – has not yet been implemented. Norwegian authorities have proposed implementing this during 2019, but in combination with a compensatory increase of the countercyclical capital buffer. This suggests that Norwegian banks may become less competitive as sources of debt financing in future.

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.
Chapter 15

POLAND

Marcin Olechowski, Borys D Sawicki and Jan Pierzgalski

I OVERVIEW

i Deal activity

Poland is the largest Central and Eastern Europe (CEE) economy, with a stable banking sector, active capital market organised by the leading stock exchange in the region (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 recent world 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 2017, 60 private equity investments with an aggregate value of €2,486 million were made into companies domiciled in Poland (compared with, for example, 86 in 2014, 128 in 2015 and 80 in 2016). Although the total number of investments was far from the highest, the total value absolutely outclassed the values in the previous years – in 2014, private equity investors invested €258 million in Polish portfolio companies, €818 million in 2015 and €758 million in 2016. There were 33 buyouts in 2017, with an aggregate value of over €2,400 million. Poland is the biggest private equity market among CEE countries, hosting 71 per cent of investments by value in the region.  

In 2017, Poland was again the largest market in the region for exits. A total of 32 divestments were valued in aggregate at €590 million. By comparison, there were 37 divestments in 2014 (€550 million), 51 in 2015 (€783 million) and 29 in 2016 (€364 million).

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 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 a certain level of earnings before interest, tax, 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 for 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 of the Polish market) tend to be time-consuming, especially because of 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.

5 Rynek private equity w Polsce 2016, KPMG.
6 Ibid.
7 Ibid.
8 Ibid.
9 In accordance with an interview with 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 and 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 exemption 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 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, because 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, lease or encumber a company’s enterprise or its organised part;
- 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 shareholders’ pre-emptive rights (the required majority of votes is four-fifths);
- dissolve the company;
Poland

k. merge, demerge or transform the company;

l. change a private company into a public company; or

m. 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.

ii. 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.

Because of 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 damage 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 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 applicable 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 (bearing in mind the ongoing Brexit process), Poland sets up very few barriers for investors from non-EU countries, as evidenced 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 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 EEA and Switzerland. It also does not 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 in companies indicated in secondary regulation issued by the government above certain thresholds (the lowest is 20 per cent) or acquisition of their enterprise require previous notification to the Prime Minister of Poland or to the Minister of Energy (depending on the business sector of the given company), either of 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 100 million zlotys or imprisonment for up to five years. As of the beginning of 2019, only eight entities (leading Polish companies in the energy and telecommunications 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 tax anti-abuse rule (GAAR);
- **b** transfer pricing documentation requirements;
- **c** mandatory disclosure rules (MDRs);
- **d** changing the withholding tax regime by a strict application of the beneficial owner concept; and
- **e** the introduction of an exit tax and the 'small' anti-abuse clause applicable to the exchange of shares and dividends.

Poland has participated in the Organisation for Economic Co-operation and Development base erosion and profit shifting project (known as BEPS) and has implemented Council Directive 2014/107/EU of 9 December 2014 amending Directive 2011/16/EU as regards the mandatory automatic exchange of information in the field of taxation (Poland started reporting from January 2017). 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 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 and Development to issue an opinion that disallows the application of the GAAR. Since 2017, tax rulings classified as tax abusive have not secured the taxpayer’s position in cases of dispute with authorities. Following the introduction of that rule, the tax authorities have conducted numerous tax audits and proceedings targeted at past optimisation projects (e.g., concerning step-ups in basis 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 now even trying to apply GAAR to tax years that predate the adoption of this anti-abuse rule. In 2019, the laws concerning GAAR were expanded and strengthened.

The most effective structures for tax optimisation of business activity carried out in Poland are Polish open-ended investment funds and special open-ended investment funds (SFIOs), except where the SFIO applies investment principles and limitations applicable to 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, because of the taxation of CIFs, the structures in which Polish and foreign CIFs participate in fiscally transparent entities were eliminated from the market. The tax administration classifies
participation in fiscally transparent entities as conflicting with the primary purpose for establishing the CIF tax exemption, namely the exemption from taxation of taxpayers’ investment activity conducted through CIFs.

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. Until 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, from 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 the economic reasons that qualify as warranting preferential taxation of mergers and demergers of companies has also been introduced. This small anti-abuse rule has also been extended to the exchange of shares (and previously, in 2016, to dividends). These exchanges will no longer be tax-neutral if there are no qualifying economic reasons for them. The tax authorities may challenge the tax neutrality of share exchanges when these are done with the sole purpose of enjoying tax benefits and not for justified economic reasons.

As regards 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, the quantity of local files has been increased). In most cases, benchmarking studies would be necessary. As from 2019, transfer pricing requirements are limited to transborder transactions; as a result, most transactions between local Polish entities are currently not subject to transfer pricing documentation requirements.

New anti-abuse rules were implemented in 2018, with the following rules in particular beginning from that year:

a. new thin-cap regulations limited the amount of tax deductible interest from intragroup and third-party financing to 30 per cent of EBITDA;

b. it is no longer possible to offset interest from loans and credits incurred on purchases of shares against revenues from business activity (debt push-downs become tax ineffective);

c. deductibility of intragroup 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 was expanded and application of the exemption based on the Parent–Subsidiary Directive was narrowed; and

e. revenues from commercial premises are now subject to lump sum tax with no tax costs deductible.

As from 2019, taxpayers and their advisers involved in tax optimisation projects are obliged to report these projects under MDRs. MDRs apply to both individual and corporate taxpayers, and require detailed reporting of any tax-effective activities, transactions and restructurings. An exit tax was also introduced in 2019; it is charged on the transfer of assets outside Poland and changes of tax residence from Poland to a foreign one. The exit tax also applies to both individual and corporate investors. In 2019, the provisions concerning controlled foreign companies were expanded and strengthened. The government also plans to change the withholding tax regime by means of a strict application of the beneficial-owner concept.
Some positive changes have also been observed in the market. The new IP Box regime was introduced with effect from 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, also with effect from 2019.

Poland has therefore 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 adopted by the authorities is found not only in relation to income taxes, but also in relation to VAT and transfer tax.

III YEAR IN REVIEW

i Recent deal activity
Although there is no statistical data available yet for 2018, market participants and observers indicate that the year witnessed a continuation of the market dynamics observed in previous years. The priority for CEE region investors is to make new investments. In November 2018, 61 per cent of respondents intended to focus on new investments, while only 25 per cent stated they would focus on portfolio management. Most investors expected the average size of transactions to remain the same (73 per cent of respondents), while 18 per cent stated that it would increase. Overall, 57 per cent of investors expected to buy more than they would sell.\(^{10}\) Investors also expect that the biggest competition between acquirers will be among market leaders.\(^ {11}\) Medium-sized growing companies remain popular but are seen as being less competitive.\(^ {12}\)

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), a fund of funds sponsored by, *inter alia*, the government. The KFK manages €110 million of funds and is focused only on small venture capital investments, providing up to 50 per cent of their acquisition financing. Another public entity operating on the Polish market is the Polish Development Fund (PFR), established by the Ministry of Treasury with the State Treasury and Bank Gospodarstwa Krajowego as stockholders. PFR holds resources of approximately 5 billion zlotys in value, provided for five funds of funds. Open pension funds are restricted from investing in the private equity market. Additionally, it is planned to establish the Capital Investments Fund, fully managed by the Prime Minister, and the main purpose of which will be to acquire shares through the State Treasury. The details regarding the Capital Investments Fund’s daily operation are currently unknown, as the Fund is still the subject of the parliamentary legislative process. However, it is likely that the relevant implementing regulation will be adopted in early 2019.

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

\(^{10}\) CE Private Equity Confidence Survey, November 2018, Deloitte Poland.

\(^{11}\) Ibid.

\(^{12}\) Ibid.
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 field. 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 of 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 patterned after 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 a security package. Depending on the available assets, the package usually consists of a share pledge, asset pledge, account receivables pledge or assignment, 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

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13 KPMG Poland; see footnote 3.
14 Time for another look – Central & Eastern Europe Private Equity, 2013, PSIK.
15 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 who are conducting an 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.
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 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 will include the right to appoint some of the management or supervisory board 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 IPO 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, from 15 to 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 more and more frequently 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 the 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 the land is in fact agricultural. As a result, in the case of any share deal, a 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.

### 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. 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 2017 was sale to another private equity firm.17

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.

Alternative investment companies (ASIs) are additional category of investment vehicles and are deemed alternative investment funds under AIFMD. ASIs are generally non-regulated investment vehicles in the form of ‘ordinary’ commercial companies that are governed by the applicable rules of the Commercial Companies Code.

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 the concentration. The acquirer should refrain from closing the deal until the UOKiK has issued a decision allowing the transaction or the statutory deadlines for the UOKiK to issue the clearance have lapsed (one or four months depending on the complexity of the transaction). 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 generally the largest CEE private equity market. Poland still hosts the highest number of companies invested. As at this point in the year in 2017, the value of private equity investments in Poland amounted to 0.535 per cent of the country’s gross domestic product, which is still higher than the European average of 0.436 per cent. These two factors, when combined, suggest that the already large market should continue to expand. A high average

17 Ibid.
rate of return on investment adds to the positive picture of Poland as the place to invest. The general impression of market participants and observers is that private equity investors are taking a bigger and bigger part in 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 have become more common.

18 Ibid.
Chapter 16

PORTUGAL

Mariana Norton dos Reis

I OVERVIEW

i Deal activity

According to the 2017 European Private Equity Activity Report, approximately €71.7 billion of equity was invested in European companies, with €51.2 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 €11.5 billion, meaning that seed, start-up and later-stage financing (venture capital) are still a reduced 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 €49.6 billion capital investment made domestically within European countries and €18.2 billion made in cross-border investments within Europe. The most targeted sectors were consumer goods and services, information and communication technology, and business products and services, with a combined percentage of approximately 64.9 per cent of all private equity investment made in Europe.

This conjuncture was reflected in Portugal, whose economic recovery positively 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 2017, with an increase of €145.4 million in comparison with the previous year. This positive development was due to an increase in the amounts invested in other private equity assets, and occurred despite a slight decrease in the investment in equity and other investments in national targets (supplementary capital contributions, accessory contributions and shareholder loans, bonds and other debt securities). Equity only accounted for 26.7 per cent of the total amount invested in the national private equity sector, while other investments appear as the major target in 2017, amounting to up to 51 per cent (€2.4 billion). Of these other investments, accessory contributions, shareholder loans and other loans take on the largest role, despite a decrease of the latter in 2017. Furthermore, amounts invested in non-domestic targets decreased by 11.4 per cent for equity and by 5.6 per cent for other investments in 2017.

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Currently, there are 46 private equity companies and 114 private equity funds operating in the Portuguese private equity sector. Investments of these private equity funds are spread out over 538 targets and investment units in 18 private equity funds, totalling €4.5 billion. Investments of the private equity companies are spread out over 63 private equity companies and investment units in 42 private equity funds, totalling €243 million. This shows that investment via private equity funds, comprising 94.9 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 64.5 per cent of total assets under management, with management being carried out by six operators, three of which manage 54.4 per cent of the global fund value. This concentration is also apparent from the fact that nine out of a total of 792 equity participations represent approximately 31.5 per cent of all assets under management registered in Portugal, and the 43 participations with a minimum value of €5 million represent 59.2 per cent of the total managed participations. There are no equity participations exceeding €100 million.

As for the targets that private equity agents generally envisage, holding companies that manage non-financial corporations that act as vehicles for investments in other companies are quite popular, as they allow end investments not to be disclosed. The sectors that captured the largest amounts of private equity investment in 2017 were the real estate and processing industry sectors, which jointly represent 19.3 per cent of the total investment in private equity in Portugal. Accommodation 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 80.3 per cent of the total investment, with the largest branch of this stage of investment being the turnaround (which represented 33.8 per cent of the total, but with a slight decrease (36 per cent) in comparison with 2016) followed by the expansion stage (21.5 per cent). This decrease in the turnaround was partially compensated by the growth of both the expansion and the replacement capital stages, which rose from an aggregate proportion of 24.2 per cent to 25.9 per cent. Despite evidencing a downturn in the number of participations, the percentage of investment captured by venture capital has not varied greatly. At this point, and contrary to the expectations occasioned by the multiple measures implemented by the Portuguese state, the start-up stage holds at 9 per cent of the total amounts investment, as against 10.4 per cent in 2016.

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 2017, 63.5 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 39.1 per cent of private equity investment had a term of less than four years and 8.8 per cent was kept for more than 10 years.

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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 or even free of charge. 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 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, either to the inbound management or to a 'storage vehicle'. For this purpose, 'good-leaver' and 'bad-leaver' provisions are used to adjust the vested equity accordingly.

A regular compensation package may be structured through '2 and 20 clauses', where the carried interest corresponds to an entitlement of the fund managers to 20 per cent of the profits and 2 per cent of the fund’s committed capital as an annual management fee. 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.

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 a non-EEA country’s nationals, either individual or legal, 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.

Under 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 disinvestments 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.

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 it 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 (known as SA companies), 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 superior to 5 per cent requires it. As for private limited liability companies (known as Lda companies), 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. 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 all acts necessary for a diligent and responsible administration of the private equity fund,

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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 €145.4 million in comparison to 2016, reaching a total of €4.8 billion by the end of 2017, the value of local private equity investment suffered a decrease of 1.1 per cent in 2017, mainly because of the decrease 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.

In early 2018, the gym chain Fitness Hut was sold to the British fund Bridges Ventures through the sale of the 50 per cent interest held by private equity holding Edge Capital.
The American fund Blackstone sold three shopping centres located on the outskirts of Lisbon (Forum Montijo, Forum Sintra and Sintra Retail Park), which were acquired by the Auchan group for a reported value of €450 million. Later in 2018, Blackstone also sold Fórum Almada to Merlin Properties, for €406.7 million.

The Portuguese fund ECS Capital divested itself of Inapal Plásticos, a company whose expertise lies in the manufacture and supply of lightweight composite components for the automotive and truck industries, which had been in its portfolio since 2010.

Alantra Private Equity and Magnum Industrial Partners each acquired a 44 per cent holding in ROQ, one of the world’s leading manufacturers of machinery and equipment for the textile printing and packaging industries, with the remaining 12 per cent stake retained by the company’s management team.

Moreover, in the telecoms sector, a consortium comprising Morgan Stanley Infrastructure Partners and Horizon Equity Partners has acquired from Altice a 75 per cent interest in its towers business, Towers of Portugal, which has almost three thousand telecoms property sites in Portugal.

**ii Financing**

Whenever private equity transactions are not carried out with resort to the equity raised by the private equity entity itself, which is the norm, private equity investors traditionally seek domestic bank financing. Despite recent signs of economic recovery, Portuguese banks are still showing risk aversion to large investment transactions, largely because liquidity has not yet reached the necessary levels for national banks to feel comfortable undertaking large-scale financing risks. For that reason, foreign banks are absorbing a considerable portion of the investment financing being resorted to in Portugal.

Debt financing structures include senior term facilities, senior revolving facilities and mezzanine facilities, which usually require robust security packages, including pledges over shares, receivables and bank balances, and even mortgages over immovable assets.

Another hurdle 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 financing of the repayment of shareholder loans or supplementary capital contributions by the target, 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).

**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 most recent transactions, parties have resorted to warranty and indemnity insurance to cover the purchaser against a breach of the representations and warranties, subject to certain limitations, and typically excluding the contingencies known by the purchaser and certain uninsurable matters.

Risk can also be mitigated by means of purchase price definition or adjustment clauses. The most common mechanisms for defining 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 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. 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 effort and cooperative obligations. The former determine 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 legal system to govern 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 2017, disinvestments were in large part made through write-off operations and third-party sales, which amounted to 37.3 per cent of the total disinvestment in private equity assets.

Following the trend of previous years, no disinvestment was 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 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: (1) the prior authorisation of the regulator for their incorporation; (2) the EU passporting system for banks and financial services applicable to the private equity fund participation units concerned; (3) disclosure to the regulator of outsourcing of management and other services; and (4) 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, Decree-Law No. 56/2018 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

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7 Regarding the supervision of managing entities of private equity investment undertakings, the Portuguese Securities Market Commission may cooperate with the Portuguese Central Bank and with the European Securities Market Authority.
8 CMVM Regulation No. 3/2015 and CMVM Regulation No. 12/2005.
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.

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. Some signs of the economic crisis remain evident in the unwillingness of domestic and foreign players to invest.

However, although turnaround and distressed transactions still represent the majority of private equity deals in Portugal, there has been a visible decrease in these types of transactions, replaced by a trend for growth investment and management buyouts. This rebalancing of distressed 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, 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 the coming years.
I OVERVIEW

Deal activity

The year 2018 was another record one for M&A activity in Singapore, largely driven by high-value outbound deals from Singapore sovereign wealth funds (SWF). According to a report by corporate finance adviser Duff & Phelps, the banking, financial services and insurance sector was the most active, followed by the real estate sector. Examples of significant outbound M&A activities include SWF GIC Private Limited’s (GIC) participation in a Blackstone-led consortium that acquired a majority stake in the financial and risk business of news group Thomson Reuters at an overall valuation of US$20 billion, and the US$14 billion investment by SWF Temasek Holdings, GIC and other investors in Ant Financial. The non-SWF M&A deals include Walmart’s acquisition of a 77 per cent stake in Flipkart Pvt Ltd (a Singapore-incorporated company with India-based operations) for US$16 billion, and the merger of Viva Industrial Trust and ESR-Reit, which is the first merger of two real estate investment trusts in Singapore through a trust scheme.

Private equity (PE) and venture capital (VC) investments in Singapore remain strong and according to Ernst & Young’s private equity briefing report, such investments in Singapore contributed to 56 per cent of the overall value of PE deals completed in South East Asia for the second quarter in 2018. South East Asia continues to attract the interest of western PE funds owing to more investment opportunities, a strong growth forecast by the International Monetary Fund and widespread capital market reforms following the financial crisis. Sectors such as consumer products and technology are the top sectors receiving such PE and VC investments.
investments. Global investment houses have increased their investment volume in South East Asia; for example, in Singapore alone, KKR has invested S$500 million for a significant stake in Singapore-headquartered V3 Group Limited, $200 million in Singapore-based real estate portal PropertyGuru, and S$45 million in Barghest Building Performance, a Singapore provider of energy-saving solutions. Other notable PE and VC deals in Singapore are the acquisition by Bain Capital Private Equity of Singapore-headquartered DSM Sinochem Pharmaceuticals for US$698 million, the US$312 million privatisation of crane supplier Tat Hong Holdings by Standard Chartered Private Equity and the family of chief executive Roland Ng, and the US$85 million close of Carousell’s Series C round led by Rakuten Ventures and EDBI, the corporate investment arm of Singapore’s Economic Development Board.

PE exits, on the other hand, have declined and the more significant reported exit is the sale of Singapore hard-drive component maker MMI Holdings Ltd by KKR for about US$645 million.

ii Operation of the market

Because of the lacklustre performance of the capital markets in recent years, the traditional public flotation of target company shares is no longer viewed as the preferred PE exit strategy. Increasingly, more PE exits are carried out through a trade sale of the target company, redemptions and secondary sales.

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 differ, 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 who 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 who 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 who 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 more common 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 who 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. However, a voluntary delisting transaction in 2018 that was opposed by its minority shareholders sparked a debate on whether there are sufficient safeguards for minority interests and triggered a review of the existing voluntary delisting regime by the regulator (see Section IV). Until there is clarity on the new regime, it is unlikely that many will adopt the voluntary delisting and exit-offer route for a take-private transaction.

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, 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

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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. 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 (SFA) 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 MAS. As the disclosure regime seeks

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17 Code of Corporate Governance, 6 August 2018.
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.\(^{18}\) A list of high-profile M&A deals in Singapore in 2018 includes:

a) Walmart’s acquisition of a 77 per cent stake in Flipkart Pvt Ltd for US$16 billion;\(^{19}\)

b) merger of Viva Industrial Trust and ESR-Reit;\(^{20}\)

c) KKR’s S$500 million investment in V3 Group Limited;\(^{21}\)

d) KKR’s S$200 million investment in PropertyGuru;\(^{22}\)

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Bain Capital Private Equity’s acquisition of DSM Sinochem Pharmaceuticals for US$698 million; and the privatisation of Tat Hong Holdings by Standard Chartered Private Equity and the family of chief executive Roland Ng for US$312.0 million.

ii 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 (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 continued liquidity and availability of funds from traditional lending sources. Therefore, despite the varied forms of financing available, debt financing nonetheless remains dominant in the acquisition financing space.

The typical debt-financing technique 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, and repayments of the debt are 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.


jurisdictions (as issues of dealing with multiple local law requirements arise). Financiers may also require additional safeguards in the form of provision of corporate or individual guarantees or support arrangements from parties related to the acquirer.

Although financial assistance prohibitions in Singapore have been relaxed, security or guarantees from the target group are generally expected to be in place only after funding and 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) still apply. As such, depending on the security matrix, clean-up periods may still feature in financing documentation, to allow time for the provision of security and guarantees by the target group. However, this timing has generally been shortened where the target is taken private or was already a private company such that financial assistance restrictions do not apply and where the acquirer has sufficient visibility over the target's assets to be able to appraise them prior to completion.

Where security or guarantees are expected to be provided shortly after the completion of the acquisition, the form of the security documents would also have been negotiated and, if possible, agreed prior to the completion of the acquisition. The feasibility of this approach 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 is not practicable, the provision of security and guarantees by the target group must be assessed and clean-up periods adjusted accordingly. 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 the 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 (e.g., 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 greater share of the entire debt package, the introduction of a mezzanine tranche is not uncommon and, if advanced, is typically provided by a financial institution or direct lending arms of funds. The mezzanine tranche may be subordinated in terms of priority of repayment and security, 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, allow for breaches of senior debt financial covenants to be resolved in collaboration with senior lenders without unnecessary interference by the mezzanine tier. The use of mezzanine tranches or mezzanine financing terms may be seen in acquisition deals where senior debt is not readily available from traditional lending sources or where the quantum of senior debt is insufficient for the purposes of the acquisition, hence necessitating further alternatives in financing structures.

**Fund-level financing**

A development in recent years has been the increased use of debt financing 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 and circumvents 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 each time an acquisition takes place).

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. 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. In the Singapore market, except for situations where

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25 PLC, 'Mezzanine finance in leveraged transactions'.

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institutional acquirers or strategic investors utilise bond issuances as a method to raise financing to fund acquisition war chests, 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.

Bond issuances have not been as prevalent for the purposes of funding the actual acquisition and purchase consideration because of the fluctuating and changing nature of the bond market (which may be insufficient to satisfy certainty of funding requirements) and are 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.

**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 intercreditor 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**

Financial assistance restrictions continue to apply to, and remain live and key issues in, acquisition deals involving public companies and their subsidiaries, despite the relaxation of the restrictions on private companies (that are not subsidiaries of a public company) in 2015. The relaxation has eased debt pushdowns and the provision of security by targets and their subsidiaries that are successfully taken private after completion of the acquisition, as private companies (and companies that are taken private) no longer have to undergo whitewash procedures to provide such financial assistance. As such, traditional challenges in structuring deals for PE investors, such as processing time and cost, may be addressed to some extent.

With the abolishment, 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.

Another whitewash procedure was also introduced to allow a public company or its subsidiary to provide what 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 existing conventional whitewash procedures, which are subject to cumbersome limitations such as the imposition of personal liability for solvency statements, extended timelines and shareholder approval. 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

b the company's board of directors resolve that the company should provide financial assistance and that the terms for doing so are fair and reasonable to the company.

Singapore case law has yet to provide definitive guidance on when PE investors and their financiers may rely on this exception, especially in the context of leveraged buyouts where the issue of financial assistance is most pertinent, but, given the origins of Section 76(9BA), Australian case law is instructive.

It has been suggested (in line with the approach taken by some Australian authorities) that 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. 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. That said, Australian authorities suggest that the following non-exhaustive assessments may be taken into consideration in determining the question of whether material prejudice exists:

a 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;

b 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;

c the opinion of the directors or any independent experts on the impact of the transaction; and

d the financial consequences of the transaction on the interests of the company, its shareholders or its creditors.

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 more recent Australian case suggests that a dilution of shareholder equity would constitute material prejudice to shareholders even if the company’s

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26 *Slea Pty Ltd v. Connective Services Pty Ltd* [2018] VSCA 180 at [72].


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.

Given the state of flux in the law in this respect, it bears mentioning that some Australian banks have refused to lend on the basis of the no-material-prejudice exception other than in very limited circumstances. While the no-material-prejudice whitewash method has been used in Singapore since its introduction, it remains to be seen whether this regime will gain traction or whether target companies will still seek to utilise the conventional whitewash methods for the purposes of the provision of security and the incurrence of debt in relation to its acquisition, pending greater clarity and guidance on the applicability of the new whitewash method.

**Exit strategies in the financing context**

Recent years have seen PE investors holding on to acquisitions for a longer period and financing strategies, options and terms have generally evolved in line with the longer exit strategies. In particular, given the restrictive terms of debt financing, there has been a greater volume of amend-and-extend transactions for existing debt facilities and refinancing of debt facilities with less restrictive financing options such as bond issuances.29

This greater volume could also be a result of the impending maturity of existing debt financings consummated during the spate of acquisitions in the early part of this decade. 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 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 Takeover 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

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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 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. Besides that, 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

Generally, the oversight of regulatory bodies such as the SIC and the SGX is relevant when the target company is listed on the SGX. The MAS is also relevant with regard to the regulation of fund management companies.

i Securities and Futures (Amendment) Act 2017

The Securities and Futures (Amendment) Act 2017 (SF(A)A) passed by the Parliament of Singapore on 9 January 2017 introduced major changes to the Singapore capital markets regulatory framework to keep pace with market developments and to align with international
standards and best practices. Most of the amendments in the SF(A)A came into effect in October 2018. Some of the key amendments to the SFA that are more relevant to M&A activities include the following:

a) The clarification that the prohibition in Section 199 of the SFA (in relation to the making of statements or dissemination of information that is false or misleading in a material particular manner) applies regardless of the effect on price. This allows the MAS to take enforcement action against a material false or misleading disclosure that may wrongly influence persons to trade in the market, whether or not it has a significant price effect.

b) The introduction of a statutory definition of ‘persons who commonly invest’ (as referred to in Sections 215(b)(i) and 216 of the SFA) that will be used as the reference point in insider trading cases to assess whether a particular piece of information is generally available and is likely to have a material price impact by influencing the behaviour of common investors. The new statutory definition will strengthen the MAS’s ability to pursue insider trading cases without having to meet an unrealistically high standard for persons who commonly invest, and the MAS will issue guidelines on the interpretation of the statutory definition.

It is important that parties to an M&A transaction are well aware of Singapore’s insider-trading and market misconduct laws, given the potential civil and criminal liabilities that may follow a breach of these laws.

ii) SGX – Dual-class shares structure

The SGX joined New York Stock Exchange and Nasdaq Stock Market, and more recently, the Hong Kong Stock Exchange, in permitting the listing of companies with dual-class shares (DCS) structures. This puts Singapore in a position to help support high-growth companies and battle for blockbuster listings. The DCS structure as contained in the SGX Listing Rules refers to a share structure of an issuer that gives certain shareholders voting rights disproportionate to their shareholding. Shares in one class carry one vote (OV shares), while shares in another class carry multiple votes (MV shares). MV shares are typically held by the company’s founders and their families, or other key executives, empowering them with voting control without the corresponding financial investment risk, and have been embraced by companies such as Facebook, LinkedIn and high-value tech start-ups known as ‘unicorns’, to protect their founders’ influence after an IPO. To guard against the risk of potential abuse of MV shares by company insiders, certain safeguards have been put in place, such as capping each MV share at 10 votes and limiting the holders of MV shares to named individuals or permitted holder groups whose scope must be specified at the time of the IPO, with

32 See footnote 30.
‘sunset’ clauses that require mandatory automatic conversion of MV shares to OV shares; and requiring an enhanced voting process where all shares, including MV shares, carry one vote each for certain corporate actions.\textsuperscript{33}

iii  SGX – Voluntary delisting

Singapore witnessed unprecedented shareholder activism when minority shareholders objected to a voluntary delisting of a target company because the exit offer price was deemed too low but they were nonetheless unable to prevent the voluntary delisting resolution (VDR) from being passed as the controlling shareholders of the company were not precluded from voting on the VDR. This prompted SGX to seek public feedback on proposals to enhance the voluntary delisting regime. In its consultation paper,\textsuperscript{34} the SGX proposed changes to two key aspects of a voluntary delisting, namely the VDR and the exit offer. The current SGX Listing Rules provide that a VDR must be approved by a majority of at least 75 per cent and must not be 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 need not abstain from voting on the VDR. In addition, an exit offer must be reasonable and should normally be in cash. To strike a balance between ensuring that minority shareholders are not unduly prejudiced and the power accorded to minority shareholders is not unduly disproportionate, it is proposed that the existing approval threshold for a VDR be reduced from 75 per cent to a simple majority of 50 per cent, and to remove the 10 per cent threshold, and that an offeror and its concert parties must abstain from voting on the VDR. The SGX has proposed enhancing the exit offer requirements such that the exit offer must not merely be reasonable, but must also be fair. It is also proposed to codify the existing practice that the exit offer must include a cash offer as the default consideration. The new proposals, if adopted, will make voluntary delisting coupled with exit offer a less attractive option for a PE sponsor acting in concert with the existing controlling shareholders of the company to privatise the company. An issue on which the SGX must provide more clarity is a situation where the offeror is unable to exercise any right of compulsory acquisition following a general offer and the free float of the target company is lost, which results in suspension of trading in the shares of the target company. If the SGX does not permit the target company to be delisted in such a situation and the free float is not restored, the offeror and the target company will be left in limbo.

iv  Code of Corporate Governance

In August 2018, the MAS announced the adoption of a new CG Code along with a new Practice Guidance, and consequential amendments were also made to the SGX Listing Rules. 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 made compulsory under the amended SGX Listing Rules, while variations from the provisions

\textsuperscript{33} Ibid.

are acceptable to the extent that companies explicitly state and explain how their practices are consistent with the intent of the relevant principle. 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; 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.

v New structure for funds – Singapore variable capital companies

In a bid to strengthen Singapore’s position as an Asian hub for fund domiciliation and management, MAS introduced a new corporate structure for investment funds, the Singapore Variable Capital Company (S-VCC), following public consultation in March 2017. The Variable Companies Bill (2018) was approved by the Singapore Parliament in late 2018 and is expected to come into force sometime in 2019.

The new S-VCC legislative framework provides for the establishment of a S-VCC 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. The umbrella structure creates economies of scale, as sub-funds can share a board of directors and have common service providers, such as the same fund manager, custodian, auditor and administrative agent. Certain administrative functions, for instance the holding of general meetings and preparation of prospectuses, can also be consolidated. While sub-funds have their own set of investors, they do not have separate legal personalities. To address the risk that the assets and liabilities of one sub-fund could be commingled with those of another sub-fund, assets and liabilities of each sub-fund are to be segregated, such that the assets of one sub-fund may not be used to discharge the liabilities of another sub-fund, or of the umbrella fund, including in the event of insolvency. This would allow 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. S-VCCs would also be able to avail themselves of Singapore’s competitive tax regime.

V OUTLOOK

In its effort to position Singapore as the leading enterprise and infrastructure financing hub in the region, the MAS announced in late 2018 certain initiatives to enhance the private markets financing channels, including a programme to place up to US$5 billion for management with PE and infrastructure fund managers. The US$5 billion private markets programme


will enhance Singapore’s private markets ecosystem and strengthen the value proposition of Singapore’s asset management industry as a gateway for investors to tap the region’s growth opportunities.\(^3^7\) One other significant development in 2018 was the launch of the Venture Capital Investment Model Agreements (VIMA), a set of standardised and easily accessible documents that investors and enterprises can use and adapt. The VIMA was intended to reduce transaction cost and friction in the negotiation process, and was jointly developed by various key industry participants, including Temasek and the authors’ firm.\(^3^8\)

In the macroeconomic setting, the threat of an escalating trade war between the United States and China creates uncertainty for M&A activity in the coming year. However, there is optimism expressed by certain groups of investors. Private equity firms such as KKR see a multitude of opportunities both because and in spite of the ongoing trade war.\(^3^9\) It believes that this situation will accelerate China’s shift away from being an export economy dependent on global trade towards becoming a more self-reliant consumer services economy – a shift that is gaining prominence, particularly within Asia.\(^4^0\) South East Asian countries that offer cheap blue-collar manufacturing labour, such as Vietnam, Indonesia and Thailand, will be the biggest beneficiaries as manufacturers shift out of China, as part of efforts to keep costs low. This shift will also help to drive the development of local automotive, information and communications technology, and apparel sectors in South and South East Asia, bringing in more advanced equipment and technical expertise.\(^4^1\) Moreover, the recently agreed Comprehensive and Progressive Agreement for Trans-Pacific Partnership, which Malaysia, Singapore and Vietnam are part of, represents the latest iteration of this trend.\(^4^2\)

However, for a majority of the countries involved, the impact of these changes will not be felt overnight and it is likely to take at least two to three years for the effects of the US–China trade war to be fully realised.\(^4^3\) Moving into 2019, Asia’s M&A activity will continue to grow, with most Asia-Pacific, or APAC, emerging economies better insulated against hikes by the US Federal Reserve than in the past but remaining vulnerable to US protectionist trade policies.\(^4^4\) While Singapore will not be spared from the headwinds facing the global economy, the level of M&A activity is likely to be sustained by virtue of its unique position as a hub for investment into the South East Asia region. The future of Singapore’s economy will depend very much on the success of the government in pushing through economic reforms and the population’s ability to embrace innovation and digitisation, and to reinvent themselves to meet the ever-changing demands of the job market.

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40 Ibid.
41 The Economist Intelligence Unit, ‘Creative disruption: Asia’s winners in the US-China trade war’, 1 November 2018.
42 Ibid.
43 Ibid.

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I OVERVIEW

Deal activity

Investments

Private equity deal activity reached a historic record again in 2018, for a second year in a row, exceeding pre-crisis levels and confirming the current excellent health of the private equity (PE) sector in Spain.

In value terms, preliminary estimates available for 2018 suggest investments of an approximate aggregate value of €5.8 billion, representing an 18 per cent increase compared to 2017. This figure significantly exceeds the record activity levels registered in 2007 (with investments in excess of €4.3 billion), evidencing the continuation of a recovery in PE investments that became evident in late 2013 after years of market downturn.

The number of transactions, however, decreased by 6.3 per cent (670 transactions compared with 715 in 2017). The gap between the increase in value and the decrease in the number of transactions evidences the higher share of large deals: in 2018, at least eight transactions exceeding €100 million were closed, representing approximately 63 per cent of the total investment value in 2018, and at least three of these were mega deals, exceeding €1 billion. Most, if not all these transactions were sponsored by global funds.

Mid-market transactions represented 25 per cent of the total investment value in 2018 (approximately €1.47 billion) with 84 per cent of transactions involving less than €5 million of investment; these also reached record levels, showing an increase of 5 per cent compared with transactions in 2017. Most mid-market transactions (44 out of 56) were closed by domestic players.

Investments by foreign players increased by 25 per cent in 2018 in terms of value, with approximately €4.5 billion invested in 118 deals. This represented 77 per cent of the total investment value in 2018 (compared to €3.6 billion or 72 per cent of the total value in 2017). In 2018, there were also transactions closed by foreign funds investing for the first time in Spain, thus increasing the number of global players in the local market.

Domestic private sponsors contributed €1.16 million to investment value (24 per cent of the total) in 2017, reflecting a slight increase in terms of value (€1 billion in 2016) but a decrease in number of transactions (449 deals in 2017 compared to 521 in 2016), evidencing some increase in the size of deals closed by domestic sponsors.

1 Christian Hoedl is a partner and Diana Linage is a senior associate at Uría Menéndez.
Buyouts represented 60 per cent of the total investment value and increased by 6 per cent in terms of number of transactions. Investment value in venture capital decreased by 22 per cent compared with the previous year’s value, although the number of transactions slightly increased from 493 to 519, showing a decrease in the average size of venture capital deals.

In terms of specific sectors, the Spanish Venture Capital & Private Equity Association (ASCRi) preliminary report for 2018 mentions 25 investments in energy and natural resources (€1.19 billion) followed by hotels, restaurants and leisure (14 investments worth €1 billion), communications (20 investments worth €1 billion), consumer products businesses (61 investments for €878 million), and healthcare (48 investments worth €237 million).

**Divestments**

In terms of volume, 295 divestment deals were closed in 2018 for an aggregate value of €2.05 billion, a 41 per cent decrease compared to 2017. Despite this significant decrease, divestments in the middle market increased both in terms of value and number of transactions (35 divestments worth €1 billion in 2018, compared to 20 divestments worth €769 million in 2017).

In 2018, the most frequently used divestment methods were secondary sales to other private equity firms (a historic high of 47 per cent of total divestments), followed by trade sales to strategic investors (24 per cent of total divestments), and buy-back by shareholders (22 per cent of total divestments).

**Fundraising and sponsors**

Fundraising by domestic sponsors exceeded €2.15 billion in 2018, a 16 per cent increase compared to the 2017 total. ASCRI estimates that private domestic participants have between €4.5 billion and €5 billion in ‘dry powder’ to be invested in Spanish companies.

**Operation of the market**

**Sale processes**

Auctions continue to be the norm in larger transactions and those involving the most valuable assets. They are also becoming increasingly common for mid-market transactions (on account of an increased sensitivity to price maximisation as opposed to deal certainty). Proprietary transactions remain more common for small private equity transactions.

Transactions and deal negotiations have tended to be less protracted than in previous years, although many still extend far beyond six months. Sellers’ price expectations remain high and have in most cases increased compared to previous years; bridging-the-gap strategies therefore continue to be seen in a number of deals.

Proprietary deals in Spain are structured as they are in most European jurisdictions. This includes an indicative offer, which, on occasion, may lead to the execution of an exclusivity agreement (of between one and three months’ duration, which is often extended), followed by a due diligence phase and the negotiation of a share purchase agreement (SPA) or investment agreement. The financing banks tend to participate in the deal negotiation at a much earlier stage than they did prior to the financial crisis. In the case of minority investments, the negotiation of the shareholders’ agreement (and the inclusion of minority protection in the target company’s articles of association) often proves more complex and time-consuming than the SPA itself.
Auction processes tend to be divided into two or three phases, in line with standards in other jurisdictions. In the first phase, potential buyers submit a non-binding, indicative offer based on their preliminary valuation of the target and setting out the likely key terms. The seller selects two or more potential buyers to enter the second stage on the basis of the non-binding offers received. In the second phase, the selected bidders are given access to a data room and other due diligence information, possibly including a vendor’s due diligence report or a ‘fact book’. At the end of this phase, potential buyers are required to submit a binding offer, including markups of the sale documentation drafted by the seller. It is not unusual for the second phase to be followed by a third during which the seller and the potential buyer enter into bilateral (although often non-exclusive) negotiations and conduct a final confirmatory due diligence.

Public-to-private transactions include a due diligence of the listed target company (approved by the target board); and the negotiation of a transaction agreement with the independent directors of the target company or the negotiation of an ‘irrevocable agreement’ with the main shareholders (whereby the shareholders undertake to tender their shares in the takeover bid to be launched by the private equity fund under agreed terms), or both. Under Spanish takeover rules, break fees of up to 1 per cent of the transaction value are allowed for the first offeror. A tender offer is mandatory if the sponsor acquires a 30 per cent stake in the company (or appoints a majority of the target company directors). Certainty of funds is a key feature of the Spanish tender offer, which must include a bank guarantee for the consideration offered in the bid, if in cash. Competing bidders must be provided the same information as the initial offeror (who, under Spanish law, only has limited ‘first-mover’ advantages). Spanish law provides for the squeeze-out of minority shareholders if, as a consequence of the tender offer, the offeror owns 90 per cent or more of the target company’s voting rights and the offer is accepted by 90 per cent or more of its addressees.

**Management incentive arrangements**

As in other jurisdictions, most private equity deals carried out in Spain include an incentive scheme to align the management team’s interests with those of the private equity investor. The management incentive package (MIP) often combines ‘sweet equity’ and a ‘ratchet’. Although each MIP is bespoke to the specific transaction, target and management team, one structure traditionally used to implement sweet equity involves the management team’s contribution to the target being made in the form of capital or common stock, while the private equity fund’s contribution is divided between equity and a participating loan or preferred shares. It is not unusual for the management team to be provided financing to enable them to purchase shares in the target. The target company may provide financing and, in so doing, profit from the exception to the financial assistance prohibition that applies to employees of Spanish limited liability companies. The risk of this type of sweet equity for the management team and the target company is that their equity-derived gains obtained upon divestment (which benefit from a lower rate of taxation) may be requalified by the tax authorities as income. The MIP is usually accompanied by entering into a shareholders’ agreement including drag-along and tag-along rights and ‘good-leaver’ and ‘bad-leaver’ provisions. In most cases, the management team is also asked to provide representations and warranties on investment and upon exit (as opposed to the sponsor, who in some cases only undertakes to provide representations and warranties on title and capacity).

Ratchets provide the management team with a bonus payment upon exit, depending on the achievement of a minimum return for the private equity fund. The hurdle is bespoke
for each MIP but often based on an internal rate of return (IRR) of between 15 and 25 per cent or one and a half to three times the money invested by the fund. To improve their tax treatment, ratchets are commonly implemented through a 'multi-annual bonus'. Under Spanish tax law, extraordinary gains generated over a period of more than two years may benefit from a 30 per cent reduction for the purposes of personal income tax. This provides a significant advantage over taxation of ordinary gains. However, the application of the reduction is limited to €300,000 of bonus payments, provided that the bonus payment does not exceed €1 million.

II LEGAL FRAMEWORK

i Acquisition of control and minority stakes

Prior authorisation

As a general rule, the acquisition of control or a minority stake in a Spanish company by a private equity fund (or, indeed, any other investor) is not subject to prior authorisation (other than as may be established in the articles of association, financing or other agreements, and other arrangements applicable to the target company). In particular, investments by private equity funds (or their investment vehicles) domiciled or incorporated abroad are not subject to any foreign investment authorisations (except if the fund or vehicle is domiciled in a tax haven); they must nevertheless be notified to the Investment Registry for administrative, economic and statistical purposes only. Exceptionally, foreign investments in certain sectors must be assessed separately. Those sectors include, inter alia: air transport; radio; minerals and raw materials of strategic importance; mining rights; television; gambling; telecommunications; private security; and arms and explosives for civil use and activities related to national defence.

The acquisition of a significant stake in specific entities (e.g., credit institutions, insurers, investment service companies) requires prior authorisation by the corresponding regulator.

Any transaction involving an economic concentration exceeding the legal thresholds established by Spanish or European law requires prior notification to the competition authorities. Competition clearance is required before the transaction can be implemented. Spanish competition law requires that the appropriate notification be filed with the National Market and Competition Commission (CNMC) if either of the following thresholds is met:

\( a \) a 30 per cent share of the national market or a defined geographical market is acquired or increased as a result of the concentration (except if the target or assets acquired in the transaction achieved turnover in Spain of no more than €10 million in the previous financial year, and provided that the undertakings concerned do not hold, individually or aggregately, a market share of 50 per cent or more in any affected market); or

\( b \) the combined aggregate turnover in Spain of all the undertakings during the previous financial year exceeds €240 million, provided that at least two of the undertakings has a total turnover in Spain of more than €60 million each.

For calculation purposes, turnover includes the overall sales of the economic group to which the undertaking belongs (excluding intragroup turnover). Portfolio companies are deemed to form part of the private equity fund’s group. The CNMC must, within one month of notification, either clear the transaction or open an in-depth second-phase investigation if
the transaction could potentially impede the maintenance of effective competition in the corresponding market. That deadline may nevertheless be suspended if the CNMC decides to request additional information from the undertakings or third parties.

If the target company holds administrative concessions, it may be necessary or advisable (depending on the specific terms of the concession contract or applicable legislation) to seek and obtain authorisation from the relevant authority for a change of control in the target, or to at least inform the authority of that change.

**Concept of ‘control’ and takeover bids for listed companies**

A private equity sponsor’s effective control of a Spanish company depends on: the company’s articles of association; the existence of voting agreements; the composition of the board; and minority protections established by law or in shareholders’ agreements.

In the context of listed companies, control of a listed target is deemed to exist where a legal or natural person, or a group of legal or natural persons acting in concert, directly or indirectly holds at least 30 per cent of the corresponding voting rights, or holds a stake of less than 30 per cent of the voting rights but appoints (prior to or within 24 months of the acquisition) a majority of the target’s board of directors. In these cases, control may be acquired by either directly or indirectly acquiring target securities with voting rights or entering into shareholders’ or voting agreements. Mandatory bids when control of a listed target is reached must be addressed to all holders of the target company’s shares, convertible bonds or share subscription rights.

**Minority shareholder rights**

Shareholders holding at least 5 per cent of the shares (3 per cent for listed companies), whether individually or aggregates, may require that the board of directors call a general meeting and include additional items on the agenda. The Spanish Companies Law (SCL) requires approval at the general meeting for acquisitions, disposals or transfers of material assets. Transactions involving consideration exceeding 25 per cent of the asset value reported on the company’s most recently approved balance sheet are presumed to be material. The SCL also acknowledges that the general meeting may issue instructions to the directors of Spanish companies.

All shareholders are entitled to request information relating to items on the agenda of a general meeting or submit any questions in writing. The board of a limited liability company is entitled to reject information requests when it considers that: the information requested would be unnecessary to protect the shareholders’ rights; there are objective reasons to consider that the information could be used for aims unrelated to the corporate purpose; or disclosure could be contrary to the company’s interests or those of its related companies. However, even if disclosure is deemed detrimental to the company’s interest, disclosure cannot be denied if requested by shareholders representing 25 per cent of the share capital (a threshold that may be reduced to 5 per cent in the articles of association). The breach of the information right only entitles the shareholder to demand compliance and seek indemnification. Nonetheless, it does not serve as a basis, with certain exceptions, to invalidate the shareholders’ resolutions. Likewise, shareholders will be liable for any damages caused by misuse of the information requested or any use that is detrimental to the company’s interest.

Shareholders representing at least 1 per cent of the company’s share capital (1 per mille in the case of listed companies) may challenge resolutions passed at a general meeting or by the board of directors that are contrary to law; the company’s articles of association;
any general meeting or board of directors’ internal regulations (as the case may be); or are detrimental to the corporate interest to the benefit of one or multiple shareholders or third parties. Abusive resolutions are considered to be detrimental to the corporate interest. The possibility of challenging corporate resolutions on the basis of mere formal breaches that have no relevant impact on the result of the constitution and voting at meetings is limited under the SCL. All shareholders are entitled to challenge resolutions that are contrary to public policy.

Finally, shareholders holding the minimum percentage to call a general meeting have standing to bring a derivative claim on behalf of the company against any director.

Non-resident sponsors

In transaction structures for foreign PE investments tax factors need to be considered, particularly the tax treatment of dividends and capital gains realised on exit. Spanish companies may benefit from rights deriving from EU directives, such as the Parent-Subsidiary Directive and the Merger Directive, or from Spain’s 80-plus bilateral tax treaties (including the amended treaty with the United States not yet in force that favours direct investment into Spain). Spain’s broad tax-treaty network with Latin America makes Spain an attractive vehicle for channelling capital investments in Latin America as well as a tax-efficient exit route for EU capital investments.

Leveraged buyouts

Structuring of leveraged buyouts (LBO) continues to be challenging. Interest payments under certain shareholder loans are reclassified as equity income and financial expenses related to LBO loans are only deductible up to 30 per cent of the target’s operating profit (or the target tax group). More importantly, the commonly used structure for debt pushdowns (the creation of a tax group or the merger of the acquisition vehicle with the target company) has been undermined by an additional limit on the tax deductibility of financial expenses: if the acquirer merges with the target, or the target is included in the acquirer’s tax group, financial expenses are limited to 30 per cent of the acquirer’s operating profit (i.e., the vehicle's expenses may not be offset against income generated by the target) unless the LBO loan represents less than 70 per cent of the consideration exchanged for the target and at least 5 per cent of the loan is amortised annually. In addition, goodwill resulting from a merger is no longer tax-deductible. The tax authorities and courts have also taken the stance that the merger between the acquisition vehicle and the target company is ineligible for the special restructuring tax regime on the basis that the merger is tax-driven and does not pursue valid business reasons.

Fiduciary duties and liabilities

Any private equity fund investing in a Spanish company must be aware of the fiduciary duties it may have as a member, or those of its directors.

Directors’ duty of care is subject to a ‘business judgement rule’ protecting discretionary business decisions taken with a reasonable standard of diligence and in the absence of a conflict of interest. The duty of loyalty comprises a wide range of duties, including, inter alia, those regarding conflicts of interest, confidentiality, freedom of judgement and independence from instructions of, or connections with, third parties (this prohibits directors from, among other actions, receiving remuneration from third parties). The company may waive some of these duties (in particular conflicts of interest) on a case-by-case basis. Some transactions require
approval at a shareholders’ meeting (e.g., to allow directors to receive remuneration from third parties, or allow the company and a director to complete a transaction for a value exceeding 10 per cent of the company’s assets).

It is also important for investors to bear in mind that directors’ fiduciary duties (and the liability that may result from the breach of those duties) may extend to persons or entities acting as shadow or de facto directors.

The SCL also imposes specific duties of loyalty on members and shareholders, including the obligation not to abuse their majority powers and – unless expressly derogated in the company’s by-laws – the right of minority shareholders to request the repurchase of their shares five years after incorporation if the company has made profits during the three preceding years and no dividends are distributed (equal to at least 25 per cent of the legally distributable profits of the relevant year or the five preceding years). Spanish courts have also upheld members’ duty of loyalty in more general terms on the basis of concepts such as contractual good faith, the duty not to act against the company’s interests and the duty not to obtain disproportionate advantages to the detriment of the company or the other members. These duties would therefore apply to a private equity fund in its capacity as a member or shareholder of the company.

III YEAR IN REVIEW

i Recent deal activity

Major deals
Several large buyout deals (exceeding €100 million) were closed in 2018, representing close to 63 per cent of the total invested value of the year and a significant increase in comparison with 2017. The energy sector was the most sought after by investors, followed by leisure, communications, consumer products, healthcare and information technology. Notable deals were all sponsored by global private equity funds, including CVC Capital Partners’ acquisition of a 15 per cent stake in Naturgy; Blackstone’s acquisition of Cirsa International Gaming Corporation, a leading gaming company with a dominant position in Spain and Latin America; Cinven’s acquisition of Ufinit Latam, a fibre-optic operator in the wholesale telecommunications market in Latin America; Orient Hontai Capital’s acquisition of Imagina (a leading distributor of audiovisual content and sports events) and the acquisition by TowerBrook Capital Partners, Torreal and Peninsula Capital Partners of a significant stake in Aernnova Aerospace, a company specialising in the design and manufacturing of aerostructures and components (the four deals exceeded €1 billion in deal value). Other relevant transactions included Cinven’s acquisition of Plantas de Navarra, an international company devoted to the production of crops and new vegetable varieties, and Ardian’s acquisition of MonBake, a group specialising in the production and distribution of bread, bakery and pastry products.

Mid-market investment value has slightly increased in 2018 compared to 2017 and represents 25 per cent of the total invested value over the year, with numerous significant transactions sponsored mainly by national private equity funds. For example, MCH Private Equity acquired a majority stake in Altafit Grupo de Gestión (a company managing gyms) and Magnum Industrial Partners and Alantra Private Equity acquired a majority stake in ROQ (a company specialising in the manufacture of machinery and equipment for textile printing and packaging). Nazca Capital acquired a majority stake in Terratest, a leading company in the soil-improvement and microtunnelling sector. Significant mid-market transactions
sponsored by international private equity funds include the acquisition by HIG Capital of the Spanish distillery Puerto de Indias, the acquisition by L Catterton of a majority stake in Goiko Grill (burger restaurants) and the acquisition by Avenue Capital of 100 per cent of Roig Cerámicas, a company that specialises in the manufacture of ceramic floor and wall tiles.

Minority investments

The acquisition of minority stakes in Spanish companies continues to be popular among private equity funds. Noteworthy transactions in 2018 included KKR's acquisition of a stake in Telepizza; GPF Capital's acquisition of a minority interest in Grupo Malasa, a Galician company devoted to furnishing; Aurica Capital's acquisition of a minority stake in restoration group Larrumba; Ysiors Capital's acquisition of a minority stake in Galecto (specialising in the biotechnology industry); the acquisition of Mecanizaciones Aeronáuticas (a Spanish manufacturer of parts for the aerospace industry) by ProA Capital; and the above-mentioned mega deal regarding CVC's minority investment in Naturgy.

Expansion investments

Private equity funds continue to contribute equity to finance the expansion of Spanish businesses. During 2018, several international and domestic private equity firms invested in Spanish companies to support their future growth, development and international expansion. For example, Ardian invested in MKD Automotive, an online platform for vehicle-fleet maintenance and repair, Gala Capital invested in audiovisual group Secuoya, and US private equity firm Summit Partners invested in Advance Medical, a company specialised in telemedicine and telediagnosis services.

Distressed investments

In 2018, there were fewer examples of distressed investments than in previous years. Distressed deals involved real estate assets in particular, but also other industries. SAREB (Spain's management entity for impaired real estate assets transferred by nationalised and other state-aided banks) made various divestments in 2018. This included, for example, selling to Redevco Iberian Ventures its 40 per cent stake in the Parque Corredor shopping centre. SAREB is expected to continue divesting assets in the coming years.

Certain domestic private equity firms also invested in 'special situations'; for example, Black Toro Capital invested in Bionaturis, a Spanish biotech company.

Exits

In 2018, Torreal sold its stake in Imagina (a leading group in the European audiovisual sector) to the Chinese private equity Orient Hontai Capital. Spanish private equity ProA Capital divested from Grupo Vips (restaurants) to Alsea. Diana Capital and GED sold their stake in Megafodo to Burger King, and Corpfin Capital and CCMP Capital Advisors sold their stake in Volotea to Apollo and Meridia.

Examples of exits through IPOs in 2018 included the divestment by Providence from Masmovil (a phone operator company) and Torreal's exit from Aston Martin (a luxury car brand).
ii Financing

The availability of acquisition financing in Spain has again significantly increased in 2018 (in terms of earnings before interest, tax, depreciation and amortisation (EBITDA) multiples financed by banks) with respect to previous years and the volume of domestic banking activity is at pre-crisis levels. Spanish borrowers currently have access to a wider range of alternative financing products after years of limited financing sources. Specialised LBO funds have become particularly active in the Spanish market, forcing banks to offer more favourable financing terms to maintain their market share.

Financing terms and conditions offered to sponsors vary depending on the type of financing products, although interest rates offered by the banks decreased during 2018. In fact, a number of deals that were largely equity-financed from 2008 to 2013 were leveraged through recaps after 2014. ‘Covenant-lite’ financings have also returned to the Spanish market.

iii Key terms of recent control transactions

Pricing formulae: locked box and bridging the gap

In a seller-friendly market, locked-box price mechanisms are clearly prevalent (as opposed to price adjustments based on completion accounts). They are sometimes used in conjunction with a ‘ticking fee’ to capture part of the cash generated by the business after the locked box accounts date. Private equity sponsors are particularly inclined to use this formula, transferring the business’s financial risk to the buyer as of the locked box date.

With sellers’ price expectations on the rise, bridging-the-gap strategies continue to challenge current deals. Vendor loans (subordinated to bank financing) and earn-outs based on EBITDA or other performance criteria, or dependent on the return obtained by the private equity fund upon its exit from the target, have been used in a number of private equity transactions. Minority investments and reinvestments by selling shareholders occasionally follow the same approach.

Conditionality

In a pro-seller market, hell-or-high-water antitrust conditions (whereby the buyer undertakes to accept any conditions imposed by the antitrust authorities to clear the transaction) are not uncommon and a strong advantage for PE acquirers when competing with strategic or corporate competitors. On the contrary, financing-out and MAC/MAE conditions and reverse break fees continue to be the exception.

Warranties

Representations and warranties, indemnities and the scope of the seller’s liability remain among the most negotiated aspects of deals. In general, private equity funds continue to invest with robust protection from representations and warranties given by the seller (other than in secondary buyouts) and to provide only limited representations and warranties upon divestment. However, in auction processes in particular, it is not uncommon for the buyer to accept that warranties are provided only as of signing (with no bring down at completion) and that the buyer’s knowledge (including as a consequence of the due diligence process) excludes the vendor’s liability.
The use of warranty and indemnity insurance in acquisition deals has significantly increased in Spain in recent years, both in PE and corporate acquisitions. In most cases the insurance was taken out by the buyer seeking supplementary protection for breach of warranties, both in terms of value and certainty of payment.

IV REGULATORY DEVELOPMENTS

i Spanish law on private equity funds and managers

The AIFMD\(^3\) was implemented in Spain through Law 22/2014 on private equity entities, enacted on 12 November 2014, which also applies to managers of private equity and similar closed-ended alternative investment funds (CEAIFs) incorporated or marketed in Spain. These managers must be authorised by the Spanish securities regulator, the National Securities Market Commission. Subject to certain exceptions and particular rules, Spanish private equity funds and companies must invest at least 60 per cent of their assets in shares, shareholder loans and instruments convertible into the equity of non-listed companies. Law 22/2014 also introduced a new type of private equity fund that invests more than 75 per cent of its assets in small and medium-sized enterprises. The Law reinforced reporting obligations; the mechanisms to monitor and prevent conflicts of interest; and the rules on the approval of remuneration and incentive policies. It also imposed restrictions on asset stripping and the requirement to designate depositaries. In addition, legal recognition was granted to European venture capital funds and European social entrepreneurship funds created by EU Regulation Nos. 345/2013 and 346/2013 respectively (as amended by EU Regulation 2017/1991).

Finally, the Law addressed the cross-border marketing and management of CEAIFs, both by Spanish managers abroad and by AIF managers in Spain (including the use of European passports for marketing European CEAIFs by managers authorised in EU Member States).

ii Tax reform

The amendments to Spanish corporate income tax that entered into force in late 2016 introduced a general restriction on deductibility of losses and impairment in equity transactions, as well as a restriction on offsetting carry-forward losses in large companies.

iii Other legislative changes

The SCL was amended by Law 31/2014 to improve the corporate governance of Spanish companies (see Section II).

Refinancing, restructurings and distressed deals have become easier to implement following two amendments to the Spanish Insolvency Law in recent years (including rules for the cramdown of dissenting creditors and for clean asset sales prior to or within insolvency).

The application of Spanish regulations on the prevention of money laundering and the financing of terrorism to private equity firms operating in Spain has also become more stringent. The obligations imposed by these rules include identifying the legal and natural persons who will take part in the transaction; cooperating with a special commission of the Bank of Spain; implementing written procedures and creating internal compliance bodies for due diligence duties.

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Finally, the Spanish Criminal Code was amended in 2015, introducing significant changes to the criminal liability of legal persons, and compliance standards.

V OUTLOOK

Private equity activity has again increased in 2018 to record levels (at €5.8 billion), confirming the growth of the previous four years). Most private equity sponsors seem to expect this trend to continue at least through 2019, if not beyond.

Liquidity (both in terms of bank and other financing and dry powder by private equity sponsors) drives up price expectations and EBITDA multiples, to the point that more and more fund managers complain about fierce competition (unless, of course, they are on the sell side) and fear that the Spanish market may be close to overheating.

Spain continues to face a number of challenges in 2019, mainly related to Catalonia and domestic politics. The private equity industry itself continues to confront its own issues, including competition by strategic buyers and family offices (mainly from Latin America) and pressure on tax structuring and carried interest.

Nevertheless, there are good reasons to be optimistic about the private equity industry in Spain. The year 2019 might witness take-privates of listed companies (public-to-private transactions, also known as P2Ps, which have been absent from the Spanish market in recent years). The deleveraging process is expected to continue for companies, which should lead to carve-outs and other divestments of non-core assets. Domestic private equity funds are raising new funds and international sponsors have a renewed interest in investing in Spain, which should guarantee an increasing amount of deals. In addition, family-owned businesses facing succession issues should continue to offer good opportunities for private equity investments. Finally, the increasing availability of financing and the high internationalisation of many Spanish businesses should also encourage investment.
I OVERVIEW

Deal activity

Fuelled by continued access to easy credit and a tailwind from newly implemented tax cuts, 2018 posted the second-best year on record for US sponsor deal activity – behind only 2007’s record numbers. Exits remained roughly flat year-on-year, with private equity (PE) firms continuing to monetise investments, returning capital to limited partners primarily through sales to strategic buyers, secondary buyouts by other private equity sponsors and sponsor-led initial public offerings. Lending to private equity-backed companies reached record levels in 2018, in part because of a surge in opportunistic refinancings and an increase in sponsor-backed M&A activity. The year 2018 also saw ‘GP stakes’ investing (private equity funds investing in the management companies of other sponsors) become more mainstream.

Buyouts

Private equity sponsors completed 6 per cent more US buyout transactions in 2018 than in 2017, with the total amount invested growing by even more – over 17 per cent – reflecting the market’s continued interest in larger deals. Private equity firms led several large buyouts, including: Blackstone’s US$17 billion acquisition of 55 per cent of Refinitiv from Thomson Reuters; the US$21 billion acquisition of Dr Pepper Snapple by JAB Holding Company and BDT Capital Partners; the US$9.9 billion take-private of Envision Healthcare by KKR; the US$5.7 billion take-private of Athenahealth by Veritas Capital and Evergreen Coast Capital (Elliott Management’s private equity arm); and Roark Capital Group’s take-private of both Sonic ($1.6 billion) and Buffalo Wild Wings ($2.9 billion). The 2018 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 28 per cent compared with 2017 – driven mostly by the large take-privates mentioned above.

Growth equity

In 2018, there was another decrease in the number of US growth equity investments by private equity firms (i.e., purchasing a minority equity stake in a mature firm), with the total...
number of deals down 4 per cent from 2017 levels. However, aggregate reported value was up over 46 per cent compared to 2017. These trends mirror the overall buyout market’s increasing focus on fewer, but larger, deals.

**Exits**

Exit volume in 2018 remained significantly below the 2014–2015 peak, with the value of 2018 exits down 15 per cent from 2015’s record, and the number of exits in 2018 down 23 per cent compared to 2015. Total 2018 M&A exits were flat when measured against 2017’s volume and down by 16 per cent against 2017’s numbers by value.

There were several notable sales in 2018. For example, in the fourth quarter, Vista sold Marketo (originally acquired in 2016) to Adobe for US$4.8 billion, and Bain, Elliott Management and GIC sold BMC Software (originally acquired in 2013) to KKR for US$8.3 billion.

The sponsor-led IPO market fell from 2017 levels: 36 PE-backed companies went public in 2018 compared with 52 in 2017; activity in 2018 was more in line with 2016, when 32 PE-backed companies went public. Notable 2018 PE-backed IPOs included security services company ADT Inc, membership club chain BJ’s Wholesale Club Holdings, Inc and cooler and drinkware company YETI Holdings, Inc.

In 2018, secondary buyouts (i.e., sponsor-to-sponsor transactions) continued to grab an increasing share of the total number of M&A exits (from 50 per cent in 2017 to 52 per cent in 2018).

Looking ahead, the market for IPOs, corporate acquisitions and secondary buyouts will continue to be important for PE firms looking to liquidate their inventory of portfolio companies, which continue to sit at an all-time high.

**Financing**

The overall volume of US debt financing was down slightly year-on-year. According to Thomson Reuters, total US dollar-leveraged lending in 2018 fell 1 per cent compared with 2017 levels (to just over US$1.3 trillion). However, US M&A financing actually increased by 18 per cent during 2018. Lending to private equity sponsors for all purposes, including M&A, refinancing and dividend recaps, jumped nearly 34 per cent – reaching record levels – driven by continued opportunistic refinancings and an increase in lending to finance acquisitions.

The 2018 buyout market saw another year of increases in leverage levels and decreases in equity contribution amounts, although both still remain below 2007’s record levels. The average debt multiple for larger broadly syndicated leveraged buyouts (LBOs) remained

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3 Source: PitchBook data.
4 Source: PitchBook (see footnote 2).
5 Source: PitchBook data.
6 Source: IPO Vital Signs data.
7 Source: PitchBook (see footnote 2).
8 Source: PitchBook data.
10 Id.
11 Id.
roughly flat at six times earnings before interest, tax, depreciation and amortisation (EBITDA), while the average debt multiple for middle-market LBOs increased from roughly 5.5 times EBITDA at the end of 2017 to 5.6 times EBITDA at the end of 2018.  

**General partner investing**

The year 2018 also saw a meaningful increase in the level of GP stakes investing, whereby private equity funds invest in the management companies of other sponsors. A record 25 GP stakes investments closed in 2018, led by funds like Dyal (a group within Neuberger Berman), AIMS (a group within Goldman Sachs) and Blackstone. 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 – Dyal, AIMS and Blackstone collectively have over US$20 billion earmarked for the strategy – a continued increase in activity is expected in this space in 2019.

**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:

- 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);
- financing risks; and
- the rules of the Securities and Exchange Commission (SEC) regarding tender offers or proxy solicitations.

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. *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

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12 Id.
13 Source: PitchBook (see footnote 2).
14 Id.
15 *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.
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. 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.

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 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.

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

16 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 be reasonably be expected to lead to a better transaction for stockholders.

17 See, e.g., *In re Topps C S'holder Litigation* (Del Ch 2007) and *In re Lear Corp S'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*.

18 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).
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 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

19 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.
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.20 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.21 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.22 In addition, recent case law has given additional clarity to deal process road maps that provide the target company with the ‘business judgement’ standard of judicial review, a standard that makes it difficult for plaintiffs to prevail.23 While this trend has had the expected effect on the volume of nuisance lawsuits in Delaware, with 2018 public company merger litigation trending down for the third consecutive year, there has been a partially offsetting increase in deal litigation in other states and federal courts as plaintiffs seek more favourable venues for claims.24

A decline was also seen in Delaware appraisal actions in 2018. 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

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20 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.

21 Cornerstone Research, Shareholder Litigation Involving Acquisitions of Public Companies, August 2016; Cain, Matthew D. and Fisch, Jill E. and Davidoff Solomon, Steven and Thomas, Randall S., The Shifting Tides of Merger Litigation (December 4, 2017).


23 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).

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, 2018 saw the volume of appraisal litigation in Delaware plummet 57 per cent year-on-year.

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 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.

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

25 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.

26 See, In re Appraisal of Dell Inc. (Del Ch. 2016); In re Appraisal of DFC Global Corp. (Del. Ch. 2016).

27 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.

28 See, In re Appraisal of Dell Inc. (Del Ch. 2016); In re Appraisal of DFC Global Corp. (Del. Ch. 2016).


30 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.
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 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;

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 (CFIUS) 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, and the applicability of the others depends on the nature of the target and, in some cases, the characteristics of the buyer as well.

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 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 vote (see the Revlon discussion, above), 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, and to indemnify its directors and officers

34 Id.
35 This section deals only with the laws of Delaware. The laws of other states may be materially different.
36 See, e.g., Abraham v. Emerson Radio Corp (Del Ch 2006).
37 See, e.g., In re Loral Space and Communications Inc (Del Ch 2008).
38 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).
39 Delaware General Corporation Law Section 102(b)(7).
against claims and expenses arising out of the performance of their board duties. 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. If a corporation is insolvent (or in bankruptcy), then the board’s fiduciary duties are owed to the corporation’s creditors, not its stockholders. 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.

**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), 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).

Using an LLC, which is treated like a partnership for tax purposes (unless an election is filed with the IRS 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.

40 Delaware General Corporation Law Section 145.
41 In re Trados (Del Ch 2013).
42 Geyer v. Ingersoll (Del Ch 1992).
43 North American Catholic Educational Programming Foundation, Inc v. Gheewalla (Del Sup Ct 2007).
44 See Ginsburg, Levin and Rocap, Mergers, Acquisitions, and Buyouts – Transactional Analysis (Wolters Kluwer, September 2015), Section 1602.3.
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:

a. senior and bridge loans, with the bridge loan usually backstopping a high-yield bond offering, typically used in very large deals;
b. 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;
c. senior and mezzanine loans, typically used in middle-market deals;
d. unitranche loans, which combine senior and mezzanine features into a single blended loan, typically used in middle-market deals; and
e. 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, 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).

45 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.
46 See discussion in Section I.
47 Many middle-market and most – if not all – larger loans are rated by credit rating agencies such as S&P and Moody’s.
IV OUTLOOK

US private equity investors are cautiously optimistic for 2019’s prospects. Although new certainty with respect to US tax policy, the continued abundance of dry powder and healthy M&A debt markets provide some tailwinds for US private equity going into 2019, concerns remain: new limits on interest deductibility, protectionist trade policies in the United States and abroad (including the threat of additional introduced tariffs on Chinese imports), competition from strategic acquirers that have new access to previously ‘trapped’ foreign cash as a result of the passage of the tax reform bill, disruption in the public equity markets, high valuations for acquisition targets and the prospect of further increases to interest rates, all could 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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Martin Abram is a founding partner of Schindler Attorneys. Before establishing the firm, he spent 15 years at Wolf Theiss, where he became a partner in 2002.

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Mr Abram holds law degrees from the University of Vienna and the University of Nottingham law school. He is admitted to the Austrian Bar.

Mr Abram has published articles regarding corporate and energy law, has contributed to several Wolf Theiss publications, and is an author and co-editor of a book on the general meeting of Austrian stock corporations.

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Ms Amorim has an extensive practice in the areas of corporate law, capital markets, securities and M&A transactions, offering legal advice on all forms of business transactions and corporate activities, including incorporation, corporate reorganisations and restructurings, assembly of joint ventures, consortiums, associations, foundations, partnerships and other methods of organising businesses, activities and enterprises, as well as advising on private equity transactions. Her experience also encompasses assistance with the acquisition and disposition of corporate shareholdings or assets, coordination and execution of due diligence procedures, divestitures, mergers and acquisitions (including management buyouts and takeovers), and assistance in the acquisition or transfer of ownership of equity interests and minority shareholdings and the structuring of public offerings.
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Mr Anderson received his BA degree in 2003 from Dartmouth College. He received his MBA and JD in 2010 from Northwestern University’s Kellogg School of Management and Northwestern Pritzker School of Law, where he was a member of the *Northwestern University Law Review* editorial board, graduated *cum laude* and was inducted into the Order of the Coif. Prior to law school, Mr Anderson spent four years working for the General Electric Company, where he was a member of the financial management programme and corporate audit staff.

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His main practice areas are local and cross-border M&A, corporate restructurings, joint ventures, privatisations and private equity investments.

Andrew has been involved in high-profile private equity transactions, having acted for Dymon Asia Private Equity (SE Asia) Fund II Pte Ltd in relation to its investment in Meiban Corporation, a leading injection moulding company, Nesta Investment Holdings Limited (which is controlled by a consortium comprising HOPU, Hillhouse Capital, BOCGI, Vanke and the CEO of Global Logistic Properties Limited) in the acquisition of Global Logistic Properties Limited by way of a scheme of arrangement.

He also advised ESR Funds Management (S) Limited (the manager of ESR-Reit) in the proposed merger with Viva Industrial Trust by way of a trust scheme of arrangement. The merger will create Singapore’s fourth-largest industrial REIT, with approximately S$3 billion in assets.

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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He is recognised as a leading lawyer and for his outstanding expertise by *Chambers Latin America, IFLR1000, The Legal 500* and *Latin Lawyer 250*. *Chambers Latin America* ranks him as a leading individual for capital markets, describing him as ‘one of the hardest-working lawyers in the market, who always goes the extra mile to ensure that everything is perfect’, and as ‘incredibly technical and methodical, as well as having great business sense and a hands-on attitude’.

He is an expert in securities and regularly advises both private and public companies on issuances in the local market and abroad. He has also developed niche expertise in CKDs. His structured finance practice is focused on providing advice to lenders on structuring complex bankruptcy-remote payment structures. He has also developed expertise in the oil and gas sector, in which he has continuously advised on capital markets, finance and M&A matters.

Mr Arangua has strong international experience. He is licensed to practise in New York and regularly advises US and other international clients on transactions in Mexico.

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He graduated with an LLB from the University of Tokyo in 1995 and with an LLM from the University of Chicago in 2002. He was admitted to practise law in Japan in 1997.
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He is a specialist in corporate and commercial and financial law and advises mainly financial institutions and AIFMs, private equity entities, and listed multinational groups.

He has worked on a regular basis for the main independent Spanish AIFMs and the major Fortune 500 and FT 500-listed multinational groups present in Spain. He is an expert in fundraising activities and the structuring of multinational private equity funds, international M&A and corporate reorganisation transactions, particularly those with a banking and regulatory element.

Jaime is a member of the Garrigues banks and savings banks, and private equity multidisciplinary groups, and takes part in numerous seminars and industry analyses.

He has been designated one of Spain’s standout corporate banking and M&A lawyers by Best Lawyers.

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Nicholas joined the Maples Group in 2004. He was previously a partner with Hammonds (now Squire Patton Boggs) in London, specialising in mergers and acquisitions as well as public company corporate finance and, prior to that, for Speechly Bircham in London.

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Dr Chung obtained a PhD degree at Seoul National University School of Law, and holds an LLM degree from Columbia Law School, as well as a Master of Laws from Seoul National University. He was named ‘M&A Lawyer of the Year’ in 2016 by Legal Times and was among the top three lawyers in The Korea Economic Daily’s ‘M&A Power Lawyers’ in 2016. Thomson Reuters magazine Asian Legal Business named him one of the ‘40 Under 40’ outstanding lawyers in the region in 2017. Dr Chung has been distinguished as a leading lawyer by Chambers Global, Chambers Asia-Pacific, The Legal 500, IFLR1000 and Legal Times in the practice areas of corporate law, M&A and private equity.

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Florian Cvak is a founding partner of Schindler Attorneys. Before establishing the firm, he was a partner at Schoenherr, where he co-headed the private equity practice. His track record includes some of the largest and most prestigious Austrian transactions, including the acquisition by a consortium of France Telecom and Mid Europa of Orange Austria, and the subsequent sale to Hutchison and Telekom Austria. Private equity and hedge fund clients include funds such as Goldman Sachs (MBD), Carlyle, Mid Europa, EQT, Riverside, PPF, DBAG, HIG, OpCapita, VR Equitipartner, Lion Capital, Mezzanine Management, Darby, FirTree and LPC Capital.

Mr Cvak’s practice focuses on corporate and corporate finance transactions in Austria and the CEE, with a particular focus on the areas of mergers and acquisitions, private equity, venture capital and LBO financings. Furthermore, he specialises in US lease and project finance transactions involving various types of utility assets. His practice is complemented by restructuring, general corporate and contracts work.

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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Ian Ferreira is a tax partner in the London office of Kirkland & Ellis International LLP. He advises on a wide range of UK and international tax matters; in particular, private fund structuring, real estate fund structuring, cross-border corporate and private equity M&A, and complex cross-border restructurings. Ian is listed as a ‘recommended’ lawyer for corporate tax in The Legal 500 United Kingdom 2017.

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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.

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Lombardi Segni e Associati
Ruggiero Gambarota has acquired significant experience in the area of corporate law, with particular reference to M&A transactions. He regularly advises both industrial and financial
entities (such as private equity funds) in connection with transactions for the acquisition of corporate stakes, for both minority interests and the majority of the relevant corporate capital. He is very active in the negotiation and structuring of ancillary agreements in this kind of transaction, such as shareholders’ agreements or joint venture or investment agreements. He has provided assistance to asset management companies and funds in connection with their investments in Italy, both in listed and unlisted entities.

Ruggero Gambarota started his professional career in 1997 with Gianni, Origoni, Grippo & Partners, working in the firm’s Rome and New York offices until 2006. In that year, he participated in the inception of Labruna Mazziotti Segni, where he became a partner in January 2008. Since 2014, he has been a partner at Lombardi Segni e Associati (formerly Lombardi Molinari Segni). Ruggero obtained his Master of Laws in corporate law from the New York University School of Law and he is admitted to both the Italian Bar and the New York Bar.

HAN GAO
Kirkland & Ellis International LLP

Han Gao is a partner in Kirkland & Ellis International LLP’s Hong Kong office. He focuses his practice on mergers and acquisitions, private equity, joint ventures, leveraged buyouts and complex cross-border transactions, as well as general corporate matters with respect to both public and private companies.

HANS P GOEBEL C
Nader, Hayaux y Goebel, SC

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 adept at managing client relationships, and is exceptional in his productivity: he provides multifaceted recommendations and solutions which are of great help to his clients’. 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 Technical Institute of Mexico (ITAM) and has lectured in financial contracts at the Ibero-American University. He currently has acted as an independent director and board secretary for various financial and non-financial institutions.
ANDRÉ LUIZ GOMES
Luiz Gomes & Associados – Sociedade de Advogados SP, RL
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.

MIGUEL A GONZÁLEZ J
Nader, Hayaux y Goebel, SC
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.

MARCO GRAZIANI
Legance – Avvocati Associati
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, also in the context of the fund industry, from negotiating rulings and APAs to representing clients in tax audits, settlements and appeals.
EKTA GUPTA  
*Shardul Amarchand Mangaldas & Co*

Ekta Gupta is a 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 Flipkart Pvt Ltd to acquire a 77 per cent stake in Flipkart 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 the two seaplane operating companies in the Maldives, which was nominated for the private equity Deal of the Year at the IFLR Asia Awards 2014.

JONATHAN HALWAGI  
*Fasken*

Jonathan Halwagi provides counsel in the areas of asset management and investment funds. His practice focuses on the establishment of fund structures with an emphasis on alternative asset management (including private equity, venture capital, infrastructure and lending). He also regularly acts for Canadian and international asset managers, assisting them with their compliance with applicable Canadian securities laws and regulations.

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 United Kingdom law firm in its investment funds group.

PETER HAMMERICH  
*BAHR*

Peter Hammerich is a partner at BAHR law firm, and head of BAHR’s asset management and private equity group. Having practised within asset management, investment funds and private equity for more than 22 years (14 as a partner), Mr Hammerich represents hedge funds, private equity funds, OEICs and other asset management vehicles, as well as their sponsors, managers, service providers, portfolio companies and institutional investors. Mr Hammerich serves in various capacities in the Norwegian Private Equity & Venture Capital Association and is a board member of several leading Norwegian asset managers. He is the author of several publications within his field of expertise.
MARKUS HEISTAD

BAHR

Markus Heistad is a lawyer at BAHR in its asset management practice group having practised within asset management for more than 10 years. Before joining BAHR, Mr Heistad held a position with the financial markets department of the Norwegian Ministry of Finance, working with financial services regulation. Mr Heistad’s practice focuses on asset management, banking and insurance regulation as well as transactions within those fields.

CHRISTIAN HOEDL

Uriá Menéndez

Christian Hoedl is a partner at Uría Menéndez in the firm’s M&A and private equity practice area. He has participated in a large number of private equity deals for national and international funds, with or without a presence in Spain, both in private and P2P deals. Mr Hoedl has extensive experience in M&A and joint ventures, and has also advised on financing, management incentives and refinancing of portfolio companies. He is regarded as one of the leading lawyers in private equity by the main international legal directories (including Chambers, PLC and Who’s Who Legal).

TRACY HOOEY

Fasken

Tracy Hooey is vice chair of Fasken’s business law practice in Ontario. Her practice is focused on securities and mergers and acquisitions. She advises public and private clients on a range of transactional matters, including securities offerings, acquisitions and divestitures, investment product structuring and corporate governance and securities law compliance matters.

Tracy also works extensively with participants in the investment product and wealth management industries. She advises clients on fund formation matters, including the structuring of public retail funds, private equity and venture capital funds, pooled funds and structured limited partnership vehicles created for special purpose acquisitions or alternative asset classes. As a result of her securities regulatory experience, Tracy is regularly engaged in transaction work in the investment product and wealth management industries, fund governance and registrant compliance matters, including for new entrants in the fintech space that require assistance navigating the securities regulatory compliance requirements.

WOJCIECH IWAŃSKI

Sołtysiński Kawecki & Szlezak

Dr Wójciech Iwański joined Sołtysiński Kawecki & Szlezak in 2006 and he specialises in private and public banking law (including payment services) and capital markets law. He advises on issues concerning the establishment of business activities by Polish and foreign entities in the banking and brokerage sector. He represents clients in proceedings before the Financial Supervision Authority (KNF). He has vast experience in advising during financing transactions, including on corporate and regulatory aspects of the acquisition of Polish regulated entities and the preparation of transaction documentation.
ALEX JORGE
Campos Mello Advogados in cooperation with DLA Piper
Alex Jorge is a partner in the tax area at Campos Mello Advogados and co-head of the tax practice, based in São Paulo. He joined the firm in 2013, bringing to Campos Mello Advogados 15 years of experience as an in-house counsel for US multinationals. Mr Jorge graduated with a BA in law from the Pontifical Catholic University of São Paulo (PUC) School of Law in 1996. He obtained an LLM in taxation from the same university in 1998 and an LLM in banking, corporate and finance law from the Fordham University School of Law in 2012. He has an extensive practice in the areas of tax planning, with special emphasis on foreign investment, tax litigation, transfer pricing and international taxation. His clients are mainly multinational consumer goods producers and direct-selling companies.

YASUHIRO KASAHARA
Nagashima Ohno & Tsunematsu
Yasuhiro Kasahara is a partner at Nagashima Ohno & Tsunematsu. His main areas of practice are cross-border and domestic M&A, private equity, joint venture and other corporate transactions. He has extensive experience in North, Central and South American matters.
He graduated with an LLB from the University of Tokyo in 2005 and with an LLM from Columbia Law School in 2012. He worked at Nagashima Ohno & Tsunematsu NY LLP from 2012 to 2014, and at Machado Meyer Sendacz Opice Advogados (São Paulo) in 2014. He is also an associate professor at the School of Law of the University of Tokyo.

ALEX KIM
Shin & Kim
Alex Kim is a foreign attorney at Shin & Kim and his main areas of practice include cross-border M&A transactions, general corporate matters, anti-corruption corporate compliance, and white-collar investigations. Mr. Kim obtained his BA at Yonsei University and holds a JD from the University of California, Berkeley, School of Law.

ROBERT KORNDÖRFER
Noerr LLP
Robert Korndörfer is an associated partner at Noerr LLP.

VOLKER LAND
Noerr LLP
Dr Volker Land is a partner at Noerr LLP.

TONG-GUN LEE
Shin & Kim
Mr Tong-Gun Lee is a partner at Shin & Kim. Mr Lee’s practice focuses on inbound and outbound M&As, joint ventures and private equity transactions. Mr Lee has been a major player in some of the most notable M&A transactions over the years. He has also advised
on high-profile hostile takeover litigation and disputes. His vast experience in friendly and hostile M&A transactions and disputes has earned him a reputation as a top-notch, go-to M&A attorney for sophisticated documentation and brilliant negotiation.

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.

Mr Lee has also authored numerous articles concerning M&A for international publications and lectured at the Judicial Research & Training Institute and Seoul National University.

**JEREMY LEGGATE**
*Kirkland & Ellis International LLP*

Jeremy Leggate is an investment funds partner in the London office of Kirkland & Ellis International LLP. Jeremy advises and represents private investment fund sponsors with respect to all aspects of the structuring and operation of alternative investment funds, focusing on a variety of strategies across various asset classes, in addition to the carried interest and co-investment plans associated with such funds.

**CHRISTY LIM**
*WongPartnership LLP*

Christy Lim is a partner in the firm’s banking and finance practice.

Her main practice areas are banking and finance, syndicated loans and cross-border financing transactions, with a strong focus in acquisition financing involving takeover offers, schemes of arrangement, delisting proposals and exit offers.

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 her ‘effective negotiating style’ has earned her ‘particular plaudits’. She is also praised for her ‘skills and proficiency’ and commended as ‘someone you would always want to have on your side’ and as someone ‘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 her ability to ‘breeze through otherwise lengthy negotiations and appreciate commercial realities on transactions’.

Appreciative clients have also commended her as 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 they have asserted that they ‘would recommend her’ and declared her to be a ‘very tough lawyer’.

Christy Lim is also identified as a leading practitioner in various other publications: *IFLR1000* for financial and corporate law; *The Legal 500 Asia Pacific, Asialaw Profiles*, the guide to Asia-Pacific’s leading law firms; *Who’s Who Legal: Banking*; and *Best Lawyers*.

She graduated from the National University of Singapore and is admitted to the Singapore Bar.
XIAOXI LIN
Kirkland & Ellis International LLP

Xiaoxi Lin is a partner in Kirkland & Ellis International LLP’s Hong Kong office. He focuses his practice on mergers and acquisitions, in which he represents public and private companies, as well as private equity firms, in a variety of complex cross-border transactions, including take-private transactions, leveraged buyouts, PIPEs, equity investments and joint ventures.

DIANA LINAGE
Uría Menéndez

Diana Linage is a senior associate at Uría Menéndez in the firm’s M&A and private equity practice area. She focuses her practice on M&A, private equity and corporate law. She has advised various private equity firms, both domestic and international, and has been involved in a number of the most important private equity deals in Spain.

IAIN McMURDO
Maples Group

Iain McMurdo is a partner in the Maples Group’s funds and investment management team and global head of private equity, specialising in the formation of private equity funds and advising on their resulting downstream transactions. He also works extensively with hedge fund managers and their onshore counsel, advising on the structuring and ongoing maintenance of hedge funds. Iain represents large financial institutions and investment managers, including well-known sponsors of private equity and hedge funds, as well as boutique and start-up investment managers. Iain joined the Maples Group in 2008. He was previously a partner at an international law firm in the Cayman Islands and, prior to that, worked for Freshfields in London specialising in takeovers and mergers.

Who’s Who Legal has ranked Iain as one of the most highly regarded individual offshore lawyers in private funds and he was recognised as Who’s Who Legal’s 2015 lawyer of the year (private funds). Iain has been featured in Latin Lawyer 250, recognised as a leading lawyer in The Legal 500 and IFLR1000, and in Legal Media Group’s Expert Guides. He has also been ranked in Band 1 as a notable practitioner by Chambers Global.

Srishti Maheshwari

Srishti Maheshwari is a senior associate working in the general corporate, M&A and PE practice group at the firm. Srishti has advised various private equity funds, agro-chemical companies, pharmaceutical companies and e-commerce companies. She also advised foreign investors on debt investments for investments in the real estate sector. Some of her key clients include Paytm, Vodafone, Blackstone and KKR.
ÁLVARO MANTECA RODRÍGUEZ
J&A Garrigues, SLP

Álvaro Manteca is a principal associate in the Garrigues tax practice, based in the Madrid office and specialising in the private equity sector and accounting law. He is a member of the tax team specialising in mergers and acquisitions, and restructuring transactions, and is also a member of the team on the firm's French desk.

He has extensive experience in the structuring of transactions for the acquisition, restructuring or divestment of both Spanish and multinational companies by international and national private equity funds. He is a member of the Garrigues private equity multidisciplinary group, and takes part in numerous seminars and industry analyses.

He provides tax consulting services on a regular basis in relation to leveraged buyouts, tender offers, stock market flotations, management buyouts and operations for the refinancing of national or international groups.

Álvaro also provides ongoing tax advisory services to international groups, with a particular focus on the media and telecommunications, information technology and automotive sectors.

FRANCISCO MARTÍNEZ IGLESIAS
J&A Garrigues, SLP

Francisco Martínez Iglesias is a partner at Garrigues in the corporate law and M&A practice in the firm’s Madrid office.

His areas of expertise include corporate law, mergers and acquisitions, and private equity, from both the M&A side and in relation to fund structuring. He is a member of the Garrigues’ private equity multidisciplinary group, and takes part in numerous seminars and industry analyses.

Francisco specialises in private equity, an area in which he has amassed extensive experience in the design and implementation of projects for the establishment of private equity and funds-of-funds vehicles. He also provides advice on numerous funds-based investment transactions, which affords him a comprehensive overview of the industry.

He has also been involved in a great number of M&A transactions and reorganisations in Spain across a range of industries (corporate, private equity and venture capital) and structures (buyouts with and without leverage, auction processes, sale and purchase of businesses, investment rounds, etc.).

Francisco Martínez has a wealth of experience in providing advice to companies, including on corporate reorganisations, and he serves as board secretary to numerous companies and multinational groups operating in various industries.

FRANK MAUSEN
Allen & Overy

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. He has 15 years of experience in these areas.
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 (ALFI) and the Securitisation working group and the Securities Committee of the Luxembourg Bankers’ association (ABBL). Frank is also a member of the Islamic Finance working group of Luxembourg for Finance (LFF – 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).

RAGHUBIR MENON

*Shardul Amarchand Mangaldas & Co*

Raghbir Menon is the regional practice head of the M&A, private equity and general corporate practice at the firm. He is an expert on matters pertaining to private equity, joint ventures, and mergers and acquisitions. Raghbir has advised many private equity and sovereign wealth funds across the full range of their operations and activities and regularly advises funds such as Blackstone, KKR, Baring Private Equity, General Atlantic, Temasek, GIC and CPPIB. He represents investment and commercial banks, private equity funds, multilateral agencies and strategic corporate clients on a variety of domestic and cross-border transactions.

Raghbir 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’, Raghbir 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, Raghbir worked with White & Case LLP, in London and Singapore, for five years. Raghbir 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).

PATRICK MISCHO

*Allen & Overy*

Patrick Mischo is the senior partner at Allen & Overy in Luxembourg. He specialises in international and corporate tax law and advises clients on the tax aspects of domestic and international private equity, real estate and debt transactions and investments, and on the structuring of Luxembourg regulated and unregulated alternative investment funds. He also has extensive experience in securitisations, structured finance and capital markets.

Patrick regularly speaks about and publishes articles on tax topics. He is a member of the Tax Committee of Invest Europe and of the board of the Luxembourg Private Equity Association (LPEA), and a member of the Tax Steering Committee within the Association of the Luxembourg Fund Industry (ALFI).
PREM MOHAN
*Kirkland & Ellis International LLP*

Prem Mohan is a partner in the London office of Kirkland & Ellis International LLP. His experience concerns all aspects of UK and EU financial regulation, with a specific focus on the regulatory issues impacting the private investment fund industry.

ANIL MOTWANI
*Shearman & Sterling*

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 is qualified to practise in New York. He has a JD from Columbia Law School and a BA from the University of Southern California.

SEAN MURPHY
*Shearman & Sterling*

Sean Murphy is counsel in the Asia investment funds practice at Shearman & Sterling.

Sean 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. Sean is also experienced in advising clients on M&A and joint venture transactions.

Sean has been invited as a faculty member for training courses organised by leading organisations, such as the Hong Kong Venture Capital and Private Equity Association.

Sean has a JD (with honours) from the George Washington University, a BA *(magna cum laude)* from the University of Pennsylvania and is qualified to practise in New York.

Sean is a native English speaker and is proficient in Mandarin Chinese.

PETER MYNERS
*Allen & Overy*

Peter Myners is the co-head of Allen & Overy’s global alternative investments 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 do from those platforms.

Peter is a member of the Executive Committee of the Luxembourg Private Equity and Venture Capital Association (LPEA), 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.

ANDRÉS NIETO SÁNCHEZ DE TAGLE

*Von Wobeser y Sierra, SC*

Andrés Nieto Sánchez de Tagle is a partner at Von Wobeser y Sierra, SC with more than 19 years’ professional experience in Mexico, New York and Latin America. His clients appear in the Fortune 50 and Fortune 500, as well as in the Dow Jones, NASDAQ, S&P 500, DAX and Nikkei. He has a multidisciplinary practice, with an emphasis on cross-border transactions, including experience in several of the principal transactions that have taken place in Mexico and the United States in the areas of banking and finance law, securities law, corporate law, and mergers and acquisitions, as well as in private equity, structured financing, project finance, arbitration and mediation.

Currently, he advises many foreign companies in relation to their most important and strategic operations in Mexico and Latin America. His clients include companies and regional and multinational financial institutions based in the United States, Canada, Germany, the European Community and Asia. He has advised clients on the development of legal strategies and solutions in relation to, among other areas, transnational acquisitions, financial operations and bank investments, incorporation of companies and associations, and reorganisations.

MARIANA NORTON DOS REIS

*Cuartrecasas*

Mariana Norton dos Reis has been a partner at Cuatrecasas in the 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.

Her practice, both in Portuguese and Spanish law, is focused on cross-border M&A, joint ventures, private equity transactions and restructurings, and she has extensive experience in renewable energy and infrastructure, advising sponsors, developers and financing entities on creating joint ventures, and acquiring, selling and developing projects.

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, NY (1998) and received a scholarship from the Luso-American Development Foundation.
Mariana lectured on the Master in Business Law in cross-border mergers at the Autonomous University of Madrid and on the Bachelor of Laws in business administration and management at CEU San Pablo University, Madrid. She is the founder and coordinator of the Women in Business (WiB) programme at Cuatrecasas and a member of the Women Lawyers’ Interest Group Committee of the International Bar Association. Mariana Norton dos Reis is a member of the Portuguese Bar Association and the Madrid Bar Association. She was admitted to the New York State Bar Association in 2000.

**RYO OKUBO**
*Nagashima Ohno & Tsunematsu*

Ryo Okubo is a co-head of Nagashima Ohno & Tsunematsu NY LLP. His main areas of practice are private equity, M&A, acquisition finance, securities law regulations and other complicated corporate transactions. He has extensive experience in matters that require expertise in both finance and corporate law, and in any type of cross-border transaction. He also frequently provides advice on technology and IT-related matters.

He graduated with an LLB from the University of Tokyo in 1999 and with an LLM from the University of Chicago Law School in 2006. He worked at Ropes & Gray LLP in Boston and New York from 2006 to 2008.

**MARcin OLECHOWski**
*Soltyśiński Kawecki & Szelząk*

Dr Marcin Olechowski leads the banking and finance practice of Soltyśiński Kawecki & Szelząk. He advises clients on complex banking and financial regulatory matters, and represents them in proceedings before the Polish financial markets regulator, the Financial Supervision Authority (KNF). His transactional experience includes a broad range of financing transactions, as well as financial sector M&A. In addition to his banking and finance practice, he is involved in international arbitration work and has represented clients in a number of high-stakes international commercial and investment arbitrations under Vienna, LCIA, UNCITRAL and ICC Rules. Dr Olechowski combines his professional career with academic work, and regularly lectures and publishes on issues of banking, civil and commercial law, as well as on international arbitration.

**JosÉ Luis Ortín Romero**
*J&A Garrigues, SLP*

José Luis Ortín Romero is a partner in the corporate law & M&A practice with a focus on financial services industry and private equity sector.

He is a regular adviser to top-tier international investors and fund management entities regarding their investments in Spain (including in the infrastructure, logistics, energy, education and financial sectors), and to Spain-based management companies. He advises both in relation to funds’ M&A activity and to the fund structuring and fundraising processes undertaken by such management companies.

He is a member of the Garrigues private equity multidisciplinary group and co-coordinator of the firm’s start-ups and open-innovation practice, and takes part in numerous seminars and industry analyses.
The Best Lawyers directory has highlighted José’s activity in the area of corporate and M&A law for the past several years. In 2017, he received *Iberian Lawyer*’s ‘40 under Forty’ award, which honours the leading 40 lawyers across Spain and Portugal under the age of 40. He is admitted to practise law in Madrid and New York.

**LUIZ AUGUSTO OSORIO**  
*Campos Mello Advogados in cooperation with DLA Piper*

Luiz Augusto Osorio is a partner at Campos Mello Advogados, based in Rio de Janeiro. He joined the firm in 2005 as an intern, became a senior associate in 2012 and a partner in 2018. He graduated with a BA in law from the Pontifical Catholic University of Rio de Janeiro (PUC-Rio) in 2005, gained a postgraduate qualification in private and property law from the same university in 2008, and a specialisation in accountancy from the Getulio Vargas Foundation in 2009. He practises in the areas of corporate law, securities, mergers and acquisitions, and contract law.

**MACKY O’SULLIVAN**  
*King & Spalding LLP*

Macky O’Sullivan is a senior associate at King & Spalding LLP. Mr O’Sullivan mainly advises clients on financial services regulation, investment funds and cross-border mergers and acquisitions. He has represented and advised clients on a broad range of corporate and investment fund matters, including the formation of and investment in conventional and shariah-compliant investment funds.

**HERNANDO A PADILLA**  
*Philippi Prietocarrizosa Ferrero DU & Uría*

Hernando A Padilla is a partner in the Bogotá office of Philippi Prietocarrizosa Ferrero DU & Uría, and head of the private equity group. His legal practice focuses on private equity, banking, finance and capital markets, and M&A. Prior to joining the firm, Mr Padilla worked as a senior associate in the New York and Paris offices of Shearman & Sterling LLP and Clearly Gottlieb. He has acted as adviser for national and international clients on M&A in Colombia and the United States.

Mr Padilla has represented domestic and international private capital sponsors in their fund formation activities. He also advised Grupo Nacional de Chocolates in its first acquisition of a company in the United States, Goldman Sachs in its acquisition of Vale’s operations in Colombia, and Darby Private Equity in its acquisition of a 5 per cent equity interest in Ocensa. Additionally, he has represented local and international investments, including Carlyle, Neuberger Bergman, General Atlantic, Altra, Mercantil Colpatria, SCL Energia and Fintra in their acquisitions and divestitures. Hernando is also a member of the finance team, where he has advised on multiple bond offerings in international markets by Ecopetrol, Emgesa, TPL, TGI, ETB and BBVA.

Mr Padilla has both a law degree and a postgraduate degree in international corporate law from the University of the Andes (1997). In addition, he has an LLM from Northwestern University Pritzker School of Law (1999) and a certificate in management from the Kellogg School of Management at Northwestern University (1999). Mr Padilla is licensed to practise law in Colombia and in the state of New York.
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Tatiana Pasqualette is an associate in the corporate and capital markets practice at Campos Mello Advogados, where she has worked for the past six years. She graduated with an LLB from the Brazilian Institute of Capital Markets (Ibmec) in 2015 and a postgraduate qualification (LLM) in corporate law and capital markets law from the Getulio Vargas Foundation (FGV) in 2019.

She has been involved in several transactions including investment funds, foreign investments in Brazil, M&A transactions, guarantees, due diligence practice, joint ventures, corporate reorganisations and restructurings. Her experience also encompasses assistance to private equities and publicly held companies in discharging their daily obligations in relation to the Brazilian Securities and Exchange Commission (CVM).

JAN PIERZGALSKI
*Sołtysiński Kawecki & Szeląg*

Jan Pierzgalski joined Sołtysiński Kawecki & Szeląg in 2013. He specialises in private banking law, corporate law and capital markets law. He advises banks, public companies and public company shareholders. He has participated in M&A transactions, financing transactions and corporate disputes.

FELIX VON DER PLANITZ
*PwC*

Felix von der Planitz is a certified German lawyer and tax adviser. He joined PwC Germany in August 2001. He has headed the German private equity fund group since July 2012. Mr von der Planitz and his team advise single fund and fund-of-fund clients around the world on fund formation, fund reorganisation, tax compliance and regulatory topics.

FEDOR POSKRIAKOV
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Fedor Poskriakov is a partner at Lenz & Staehelin in the banking and regulatory group in Geneva and specialises in banking, securities and finance law. He regularly advises on various regulatory, contractual and corporate matters. His practice covers banking, investment management and alternative investments, including private equity and hedge funds. He also advises on complex asset structuring and protection for business and private assets. His other practice areas include compliance advisory, internal investigations and private clients. Highlighted as a 'next-generation lawyer' (*The Legal 500 2017*), Fedor Poskriakov ‘is a highly reputed banking and finance specialist who handles complex matters for Swiss and international clients’ (*Who’s Who Legal 2017*). Mr Poskriakov is admitted to the Bar in Geneva. He has a law degree (lic. iur.) from the University of Geneva.
QUAK FI LING
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Quak Fi Ling is a partner in the firm’s corporate and M&A practice and private equity practice. Her main practice areas are public and private M&A, private equity investments and corporate and commercial transactions.

Fi Ling has acted for private equity firms in both public and private M&A transactions. Her recent public M&A transactions include acting for a consortium comprising HOPU, Hillhouse Capital, BOCGI, Vanke and the CEO of Global Logistic Properties Limited (GLP) in the privatisation of GLP; and advising Baring Private Equity Asia in the sale of its stake in Courts Asia Limited. The GLP acquisition deal was awarded ‘Deal of the Year’ and ‘Best Leveraged Finance Deal’ at FinanceAsia’s 2017 Achievement Awards, ‘M&A Deal of the Year: Southeast Asia’ at The Asian Lawyer’s 2018 Asia Legal Awards, and ‘M&A Deal of the Year (Premium)’ at the Asian Legal Business 2018 SE Asia Law Awards.

In the private M&A space, Fi Ling has acted as Singapore counsel to Bain Capital Private Equity in the acquisition of DSM Sinochem Pharmaceuticals (a joint venture between Dutch chemicals firm Royal DSM NV and China’s Sinochem Group); and to a Canadian pension fund in its acquisition, from an Alpha Investment Partners managed entity, of Cape Investments II Pte Ltd, which owns the commercial property located at 78 Shenton Way, Singapore.

Fi Ling is recognised as a recommended lawyer in the area of corporate and M&A by The Legal 500 Asia Pacific, in which she has been described as ‘commercial and calm under pressure’, and she is recommended 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.

ANABEL QUESSY
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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.

DEEPA REKHA
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Deepa Rekha is a senior 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
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STEPHEN L RITCHIE
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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 2018, for his work in private equity buyouts.

Mr Ritchie has handled many private equity, LBO, 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.

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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), FCPA/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 Bar in New York.

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.

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**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 he 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 College of Regulatory Compliance.
ENZO SCHIAVELLO

Legance – Avvocati Associati

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, NPL 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 GP-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, Kenner, 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. Besides 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
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KEIKO SHIMIZU  
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Keiko Shimizu is a partner at Nagashima Ohno & Tsunematsu. Her practice focuses on securities and financial services regulations, among other things, and she advises asset management companies, securities brokers, banks and other financial institutions on corporate governance, regulatory and compliance matters. She also advises clients on the formation, marketing and operation of various collective investment vehicles, such as investment trusts, hedge funds, private equity funds and funds of funds. She also handles a variety of corporate transactions and general corporate affairs, and advises clients on data protection matters (including compliance with the Personal Data Protection Act of Japan).

She earned an LLB from the University of Tokyo in 1996 and an LLM from Columbia Law School in 2003. She was admitted to practise in Japan in 1998 and worked at the New York office of Davis Polk & Wardwell LLP as a visiting attorney in 2003. She was a partner at Nagashima Ohno & Tsunematsu NY LLP from 2015 to March 2018.

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Sayf Shuqair is an associate at King & Spalding LLP, based in the firm’s affiliated Riyadh office. Mr Shuqair mainly advises clients on the structuring, formation and governance of various types of investment funds, including private equity, venture capital and real estate investment funds, and also generally advises clients on innovative corporate and investment structures. He also advises clients on private equity, capital markets and real estate transactions in the UAE and Saudi Arabia.

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.

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Taranjeet Singh is a senior 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 the 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, Invus, KKR and Urbaser. His notable transactions include advising Blackstone in relation to the 100 per cent buyout of the 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 stake 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 Car Trade; 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.

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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 (PUC-Rio) in 2002; obtained a lato sensu postgraduate qualification (LLM) in corporate law and capital markets law from IBMEC in 2005; a lato sensu postgraduate qualification in tax law from the Brazilian Institute of Tax Studies (IBET) 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 mergers and acquisitions.

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 private equity, real estate, infrastructure, debt and hedge funds. 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 is co-chairman of the Infrastructure Funds working group of the Association of the Luxembourg Fund Industry (ALFI), as well as a member of its Alternative Investments Committee, its AIFMD Review and Developments working group, its Depositary Bank Forum and New Regulations Forum, and its EMIR/OTC Derivates working group. He is also a member of the UCI and SICAR Committees of the Luxembourg financial regulator, the Financial Sector Supervisory Commission (CSSF).
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Dr Chang-Hyun Song is a partner at Shin & Kim in the firm’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 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 (JSD) 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.

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James Stull is a partner at King & Spalding LLP. His practice covers a broad range of corporate, finance and investment matters. He primarily focuses on asset management and the formation of investment funds, including venture capital funds, private equity funds, real estate funds, credit and debt funds, hedge funds and shariah-compliant funds. His practice includes advising domestic and international clients on the corporate and regulatory aspects of structuring, establishing and liquidating various fund structures, and he has substantial experience with securities regulations in the UAE, Saudi Arabia and other Middle East jurisdictions, as well as in the United States.

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 has solid experience in advising clients on issuances in the local securities market, particularly in the case of development capital 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 (ITAM) and he also previously worked as a foreign associate in the Amsterdam, Luxembourg and Geneva offices of Loyens & Loeff.
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Iris Wang is a registered foreign lawyer in the Asia investment funds practice at Shearman & Sterling, in the Hong Kong office.

Iris works on transactions for both GPs and LPs in Asia. She helps private equity and hedge fund sponsors on asset management and fund-related matters and has acquired an extensive understanding of fund structuring and regulatory issues in relation to fund managers.

Iris is qualified to practise in both New York and China. She graduated from KoGuan Law School, Shanghai Jiao Tong University as an outstanding graduate, and received an LLM degree from the New York University School of Law.

JAMES YONG WANG
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James Wang has 18 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 over 1,000 domestic and offshore PE, VC, hedge, real estate, mezzanine, film and media, energy and infrastructure funds, QFLP and R-QFLP funds, QDLP and QDIE funds, QFII and R-QFII funds, and QDII 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, IFLR 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 2018 (the only lawyer with a Chinese 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.

MICHAEL P WHITCOMBE
McMillan LLP

Michael P Whitcombe is the chair of the board of partners and the national co-chair of the private equity group at McMillan LLP.

Since 2006, Michael has been recognised as one of Canada’s leading business lawyers in The Lexpert/American Lawyer Guide to the Leading 500 Lawyers in Canada.

He principally practises in the areas of negotiated merger and acquisition transactions (domestic and cross-border), private equity investments, strategic alliances, complex commercial arrangements and corporate governance. Michael regularly advises private equity firms along with other medium and large corporations (both domestic and international) and their boards of directors in connection with their operations throughout Canada. He
has significant industry experience in the pharmaceutical, automotive, manufacturing, distribution, service, entertainment, hospitality and tourism sectors. He is a director of a number of Canadian corporations, including Porsche Cars Canada Ltd. Michael obtained a degree in business administration (BBA) in addition to his LLB and LLM, and was called to the Ontario Bar in 1987.

Michael P Whitcombe’s significant clients include Sun Capital, Oaktree Capital, Arlon Capital, Thoma Bravo, Genstar, Blue Point Capital, Nordic Capital, Novarits and Porsche Canada.

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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.

MAXI WILKOWSKI
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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.

ADELE ZITO
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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 Bonelli Erede 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. She has been with
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Appendix 2

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