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VON WOBESER Y SIERRA, S.C.

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The sixth edition of *The Private Equity Review* comes on the heels of a solid but at times uneven 2016 for private equity. Deal activity and fundraising were strong in North America, Europe and Asia, but the year ended with uncertainty in the face of Brexit, a new United States administration and continued challenges in developing economies such as Brazil. Nevertheless, 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. As large global private equity powerhouses extend their reach into new markets, home-grown private equity firms, many of whose principals learned the business working for those industry leaders, have sprung up in many jurisdictions to compete using their local know-how.

As the industry continues to become more geographically diverse, private equity professionals need 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 29 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.

While no one can predict exactly how private equity will fare in 2017, it can confidently be said that it will continue to play an important role in the global economy. Private equity by its very nature continually seeks out new, profitable investment opportunities, so its further expansion into growing emerging markets is also inevitable. It remains to be seen how local markets and policymakers respond.

I want to thank everyone who contributed their time and labour to making this sixth edition of *The Private Equity Review* possible. Each of them is a leader in his or her respective market, so I appreciate that they have used their valuable and scarce time to share their expertise.

**Stephen I Ritchie**  
Kirkland & Ellis LLP  
Chicago, Illinois  
March 2017
Part I

FUNDRAISING
Chapter 1

AUSTRALIA

Deborah Johns

I GENERAL OVERVIEW

In Australia, private equity (PE) and venture capital (VC) fundraising continues to be strong based on available data. PE and VC funds targeting wholesale investors are lightly regulated (as discussed in more detail below), and as such there are no public records to verify PE and VC fundraising activity.

However, the Australian Venture Capital and Private Equity Association Limited (AVCAL), an industry association representing both PE and VC, publishes a yearbook for each fiscal year ending 30 June. FY2016 figures are based on the activities of 75 VC and PE firms. The information for the FY2016 Yearbook was obtained via direct submissions to AVCAL, and other sources such as firm websites, press releases and industry news sources.

AVCAL’s data focus on Australian fund managers – funds managed by an overseas fund manager are not included unless the fund manager allocates a specific amount to Australian investments. It also disaggregates PE from VC based on a fund’s target investments as follows: VC funds make equity investments for the launch, early development or expansion of a business, typically in an innovative/high-tech product or service, and include seed, early stage, later stage and balanced VC funds (but do not include anything included in the definition of ‘private equity’); private equity refers to growth/expansion, generalist, buyout/later stage, turnaround, secondary and mezzanine funds.

Based on these data, A$2.172 billion in new capital was raised by PE fund managers in FY2016 (slightly less than the A$2.549 billion raised by PE managers in FY2015, but still in excess of the prior two years combined); and 10 PE fund managers successfully raised capital in FY2016 (up from nine in FY2015).

A number of established fund managers raised new funds in FY2016, while a few others are likely to begin raising in the next 12 to 18 months along with some potential new entrants into the market.

The VC fund industry is extremely active. Although AVCAL reports that only seven VC funds were raised in FY2016, they raised A$567.93 million in FY2016, one of the most active years on record.

A number of trends are evident. The first big trend on the VC front was the record fundraising year, driven by the coincidence of fundraisings by the most successful VC fund managers and the willingness of domestic superannuation funds to return to the sector to participate in those raisings.

1 Deborah Johns is a partner at Gilbert + Tobin.
There has also been increasing interest among corporates, universities and the government, who either have established or are considering establishing special purpose funds for making VC-style investments.

The outlook for FY2017 is strong. The government previously announced that it would contribute A$250 million of matching capital to fund managers raising funds in the biomedical commercialisation space. The government has now selected the successful fund managers, and all of these funds have had or will have in the near future first and final closings, bringing the total capital raised for VC in FY2017 already to near the level raised in FY2016, with several funds still in the pipeline.

These high notes overshadowed a less visible negative trend, which is that the expected flood of persons applying for significant investor visas (visas granted to persons who invest A$5 million in Australia, including A$500,000 into VC funds) never materialised. The significant investor visa programme was revamped in FY2015 to include a compulsory VC component, and as a result a large number of small funds were established in FY2016 expecting to take advantage of the new VC requirements. However, many of these have not yet been able to achieve a first closing at the required minimum of A$10 million because people are not applying for significant investor visas in the volume expected.

Although there was a slight decrease in the amount of money invested in PE funds in FY2016 (A$2.172 million in FY2016 as compared to A$2.549 million in FY2015), this was spread across more funds and continues to be well in excess of the levels seen in FY2014 (A$933.27 million) and FY2013 (A$719.93 million). Some of this appears to have been fuelled by subsequent closings for funds that had been included in AVCAL’s FY2015 statistics.

FY2016 fundraising on the PE front continued to be dominated by overseas investors, which accounted for 83 per cent of new capital for PE funds, while overseas investment was less significant for VC funds (less than 10 per cent of new commitments). Overall, investors broke out by region roughly as follows:

- North America: 38 per cent;
- Australia: 32 per cent;
- Asia: 13 per cent;
- Europe: 12 per cent; and
- other: 5 per cent.

Superannuation or pension funds, corporate and financial institutions and fund-of-funds were the most significant investors in PE funds in FY2016.

The formal process of documenting a fund – from information memorandum to first closing – generally takes four to six months. However, the actual time it takes to raise a fund varies significantly depending on the fund manager and the extent to which it can rely on existing LPs to ‘re-up’ for a new fund.

For funds that are established as VCLPs or ESVCLPs (defined below), there is a registration component that currently takes about six to eight weeks (described below).

---

2 Source: AVCAL FY2016 Yearbook.
3 Ibid.
4 Ibid.
II LEGAL FRAMEWORK FOR FUNDRAISING

Most PE funds established by Australian fund managers consist of one or more Australian-domiciled vehicles (described below). The Australian tax treatment for both domestic and non-resident investors in Australian-domiciled vehicles is described in Section III, *infra*.

Occasionally the fund structure may include one or more overseas vehicles (such as Delaware, Cayman Islands or Jersey partnerships). This is usually to facilitate investment by non-resident investors in investments outside of Australia.

Australian PE funds are usually formed as a combination of Australian-domiciled unitised trusts (often structured to fit the managed investment trust (MIT) regime and the attribution managed investment trust (AMIT) regime, described below) and a particular form of Australian limited partnership called a ‘venture capital limited partnership’ (VCLP), with investors investing in one or both of these depending on their investor profile. Australian-domiciled VC funds are typically established as a VCLP, as an ‘early stage venture capital limited partnership’ (ESVCLP) or as a unit trust qualifying as a MIT or AMIT, depending on the kinds of investments the fund will target and the profile of the investors.

These vehicles are described in more detail below.

i Unit trusts

A unit trust creates a contractual relationship between unitholders (investors and beneficiaries) and a trustee (legal holder of the property and manager) under a trust deed or constitution. As a unit trust does not have a separate legal personality, the trustee contracts on behalf of the trust subject to a general provision limiting the trustee’s liability to the assets of the trust.

A unit trust is managed by a trustee, manager or both. The trustee usually has the right to deal with the trust assets on a discretionary basis on behalf of the investors. A management entity is often appointed by the trustee within the structure to advise them, although this is mainly for fee-streaming purposes.

ii MITs

The MIT regime was introduced in 2010 due to the uncertain tax treatment of gains with unit trusts. A MIT is essentially a unit trust with certain characteristics.

Numerous tests must be met to qualify as a MIT, such as:

- a for tax purposes the trustee must be an Australian resident;
- b the trust cannot be a trading trust;
- c a substantial portion of the investment management activities must be carried out in Australia in regard to certain assets;
- d the trust must be a ‘managed investment scheme’ at the time the payment is made for Corporations Act purposes;
- e the unitholding must satisfy concentration of ownership requirements; and
- f in some cases, the trust must be managed by a licensee who has an Australian financial services licence (AFSL) that permits it to provide financial services to wholesale clients.

In exchange, the MIT provides greater certainty in terms of tax treatment. See Section III, *infra*, for further details.

In late 2015, the government introduced into parliament a new tax system for eligible MITs (known as ‘attribution MITs’ (AMITs)). From 1 July 2016 (or, by election, from
1 July 2015), these new rules, among other things, make available to eligible AMITs, a new attribution method (rather than the existing trust tax rules) to attribute specific classes of income, offsets and credits to unitholders, based on their entitlements; the ability to attribute any under or over distributions to unitholders during the income year the discrepancy is discovered; and tax treatment akin to a fixed trust, assisting the flow through of franking credits and carried forward tax losses.

To be eligible as an AMIT, a trust must be a MIT, and the trust deed must clearly define the entitlements of all unitholders to the trust’s income and capital. These eligibility requirements must be met for each income year. Should the requirements not be satisfied, the trusts will continue to be taxed under the normal trust taxing provisions. The AMIT regime does not change the current MIT withholding tax rate.

### iii VCLPs and ESVCLPs

The VCLP regime was introduced in 2002 to increase foreign investment in the Australian VC sector by offering a familiar fund structure (the limited partnership) with tax benefits (see Section III, infra, for further details) in exchange for making investments in Australian businesses that meet certain eligibility criteria. Because of these restrictions, VCLPs have largely been restricted to VC and mid-market PE funds.

A VCLP must have a minimum capital raising of A$10 million by investors to be formed. VCLPs generally have a life of five to 15 years.

The requirements for a VCLP include that investments can only be made in shares or options in a company or units in a trust; the target needs to have an Australian nexus (subject to certain exceptions); and the target cannot have more than A$250 million in total assets (including goodwill).

The ESVCLP is essentially an extension of the VCLP regime. It was introduced to encourage early stage VC investment by offering further taxation advantages for investors (see Section III, infra, for comments regarding the tax treatment of ESVCLPs) provided the fund only invests in early stage investments and meets certain other tests. Despite these restrictions, the ESVCLP structure has gained popularity with high net worth investors who value the tax advantages offered by the ESVCLP and want exposure to early stage VC.

Australian PE and VC fund documentation has become reasonably standardised for similarly structured funds, although the terms can significantly vary. Although the documents may look very different to partnership agreements seen overseas, the overall coverage is the same, including:

- procedures for admitting investors and dealing with fund interests;
- procedures for capital calls, capital call relief events and dealing with investor defaults;
- management fees, offsets for outside fees and recoverable expenses;
- distributions, including the distribution waterfall;
- procedures for removal of the general partner, trustee or manager (for cause and for convenience), termination fees and post-removal carried interest;
- governance, including:
  - powers and duties of the general partner, trustee or manager, including the right of indemnity out of fund assets for actions taken on behalf of the fund;
In general, Australian fund terms are starting to be more aligned with international funds, as the influence of non-resident investors on PE fund documentation is felt. Although there has been a general shift in negotiating power towards LPs, top fund managers are still able to raise funds on favourable terms.

In Australia, wholesale investors (persons investing more than A$500,000 and institutional and professional investors) are the investors typically targeted by PE and VC funds. Australian law does not require disclosure to these parties for issues of interests in PE and VC funds (such as through a prospectus or product disclosure statement), but does require that the fund manager not engage in misleading or deceptive conduct.

As long as offers are made only to wholesale investors (described above), the most common method of solicitation of investors for fundraising is to distribute a private placement memorandum to interested parties that outlines the details of the fund and the investment plan.

In these cases, there are no real limitations on such solicitation, although the fund manager must hold or be an authorised representative under an AFSL (discussed below) with appropriate authorisations covering the financial services being provided; and for VCLPs, ESVCLPs, MITs and AMITs, the number, mix and identity of investors will be relevant for ongoing registration and eligibility requirements, so this will affect solicitations.

Trustees of PE and VC funds formed as unit trusts have duties in equity to act in the best interests of members. These duties will be reinforced through a trust deed that establishes the trust. General partners and fund managers typically have similar duties imposed upon them by contract.

Managers of funds are required to hold an AFSL to provide financial services. The AFSL imposes duties to act efficiently, honestly and fairly, effectively imposing fiduciary obligations upon the licensed entity to investors.

All of the available fund entities are generally flow-through vehicles with respect to the income and profits of the vehicle being taxed in the hands of the investor (however, see comments below regarding MIT withholding tax (MITWHT), and withholding tax on dividends and interest paid to non-residents).

The Australian income tax consequences for investors will depend on the character of the gains derived by the vehicle. The view of the Australian Taxation Office (ATO) is that, as a starting premise, gains made by PE funds are treated as being of an income character (as opposed to being of a capital nature).

The requirements for a unit trust to be a MIT and for a limited partnership to be a VCLP or ESVCLP are prescriptive and extensive. However, where they are met, they offer certainty of Australian income tax treatment for overseas (and in some cases domestic) investors, as described in more detail in Section III, infra.
III REGULATORY DEVELOPMENTS

For wholesale PE and VC funds, there are two main sources of regulation.

First, Australian Securities and Investments Commission (ASIC) has regulatory oversight of the operation of PE and VC funds in Australia through its financial services licensing function (described in more detail below).

Second, a fund manager is regulated under Australia’s anti-money laundering and counter-terrorism financing laws (also described in more detail below).

AVCAL released a code of PE governance in 2011. AVCAL was established to promote and represent the interests of the PE and VC industries in Australia. The code outlines principles to assist PE and VC firms to be better governed. Compliance with these principles is not, however, compulsory. Regardless, investors expect managers, general partners and trustees to follow the principles and to report to investors when they do not comply with them.

Where the fund targets and accepts investment from wholesale investors only (described above), the fund does not need to be registered with ASIC.

If issues of interests in a PE fund are to retail persons, the fund will need to be registered, and additional licensing, financial and disclosure requirements will apply to the fund manager.

Australian VCLPs and ESVCLPs must be registered as incorporated limited partnerships in a state, and as a VCLP or ESVCLP with Innovation and Science Australia (the federal government body that oversees the VCLP and ESVCLP programme).

i ASIC

Typically, a domestic PE or VC fund manager will be obliged to hold, or be an authorised representative under, an AFSL, which will set out the authorised activities that the manager may perform. Generally, the licensed or authorised entity may be the manager of the fund, the trustee of the trust or general partner of the VCLP or ESVCLP.

Many international PE and VC funds carrying on business in Australia may be able to obtain licensing relief where they have only limited connection to Australia or where Australia and their home jurisdiction have implemented ‘passporting’ arrangements.

The AFSL licensing regime requires entities to prepare and lodge audited accounts publicly and to comply with strict compliance requirements. ASIC has the right to inspect books and records of such entities with regard to compliance with the Corporations Act at any time.

Authorisations covered by an AFSL are publicly available information.

ii AUSTRAC

By issuing fund interests, a fund is providing a designated service under Australian Anti-Money Laundering and Counter-Terrorism Financing legislation (AML/CTF) and needs to comply with the AML/CTF as a reporting entity.

As a reporting entity, the fund is subject to the following obligations:

- enrolling with AUSTRAC (the regulator);
- performing investor identification and verification and ongoing investor due diligence, including monitoring transactions;
- reporting to AUSTRAC suspicious matters within 24 hours or three business days, as required;
reporting to AUSTRAC transactions greater than A$10,000 within 10 business days after their occurrence;

providing AUSTRAC with compliance reports;

implementing and adhering to an AML/CTF programme that includes the designation of an AML/CTF compliance officer, systems for identifying, mitigating and managing risks, employee risk awareness training and due diligence programmes, transaction monitoring, independent review of the AML/CTF programme and investor identification and verification procedures; and

retaining records relating to investors and retaining each AML/CTF programme in force for a period of seven years after the record ceases to be in force.

The reporting obligations include the disclosure of the identity of the fund’s investors and sponsor’s members when reporting to AUSTRAC.

### MITs

Where a MIT is used as the fund vehicle, the MIT is able to make an election to deem certain gains made by the MIT to be on capital account, effectively providing a statutory safe harbour against the ATO position described above. This means potential concessional tax rates for certain Australian investors. Furthermore, non-resident investors in a MIT will generally not have any Australian income tax liability unless the relevant capital gain made by the MIT is in relation to taxable Australian property (for example, interests in land and non-portfolio interests in land-rich entities) or the non-resident investor has a permanent establishment in Australia.

Subject to meeting certain additional requirements, distributions to non-residents by a MIT of certain non-tax exempt amounts may qualify for MITWHT at a 15 per cent rate (depending on the nature of the income distributed (see below for details) and the tax residence of the investor). However, where the investor is a resident of a country other than an ‘information exchange country’ (as defined by income tax regulations), the applicable rate of MITWHT is 30 per cent. A 10 per cent rate may be available for eligible distributions by MITs which hold only certain energy-efficient buildings constructed from 1 July 2012.

This withholding tax will apply to various distributions, including distributions of taxable capital gains (namely, capital gains derived in relation to taxable Australian property) and income that has an Australian source (such as rental income in relation to land situated in Australia). Unfranked dividends and interest paid to a non-resident investor by a MIT are not subject to MITWHT and instead are subject to different withholding rates (generally 30 per cent in the case of an unfranked dividend (subject to the operation of any applicable double tax agreement (DTA)) and generally 10 per cent in the case of interest).

Because Australian resident investors are taxed by assessment, a MIT does not generally need to withhold from amounts paid to Australian resident investors.

### VCLPs

Where a VCLP is used as the fund vehicle, subject to certain exceptions, both income and losses are attributed to investors. Australian investors will need to include the relevant partnership profit in their assessable income or claim the corresponding deduction for any loss. Subject to an exception that applies to certain superannuation investor entities, unlike
for MITs there is no statutory safe harbour for gains made by a VCLP. Such gains may be regarded by the ATO as gains made on revenue account (such gains will not be concessionally taxed as capital gains).

Certain non-resident investors (such as tax-exempt foreign residents, a foreign VC fund of funds and where the foreign investor holds less than 10 per cent of the VCLP’s committed capital) are given a specific exemption from Australian income tax on gains made in relation to investments held by the VCLP. If a non-resident investor does not satisfy the exemption criteria, it may have an Australian income tax liability in relation to gains made by the VCLP.

There is no withholding tax on distributions of gains on investments made by a VCLP to non-residents.

Unfranked dividends or interest derived by the VCLP and paid to a non-resident investor are subject to withholding (generally 30 per cent in the case of an unfranked dividend (subject to the operation of any applicable DTA) or generally 10 per cent in the case of interest).

Because Australian resident investors are taxed by assessment, generally no amount needs to be withheld from amounts paid to them.

v ESVCLPs

Where an ESVCLP is used as the fund vehicle, subject to certain exceptions, both Australian investors and foreign investors may be entitled to tax-free returns in Australia from the ESVCLP.

Key tax features of the ESVCLP regime for investors include:

a a limited partner’s share of any gain or profit from the disposal or realisation of an eligible VC investment by the ESVCLP is exempt from Australian income tax, if the partnership owned the investment for at least 12 months;

b a limited partner’s share of income derived from an eligible VC investment (for example, dividends paid by an investee) held by the partnership is exempt from Australian income tax. Unfranked dividends or interest derived by the ESVCLP and paid to a non-resident investor are subject to withholding (generally 30 per cent in the case of an unfranked dividend (subject to the operation of any applicable DTA) or generally 10 per cent in the case of interest); and

c a capital gain or capital loss arising from the disposal of an eligible VC investment by the ESVCLP is not made by the ESVCLP but is made by the limited partners. Such a capital gain or capital loss from the disposal of an eligible VC investment will be disregarded for Australian income tax purposes if the ESVCLP owned the investment for at least 12 months.

Losses made by an ESVCLP are typically not deductible to investors.

The government announced several changes to the ESVCLP regime in late 2015. The most concessional change is the introduction of a non-refundable tax offset of 10 per cent of the value of new capital invested for new ESVCLPs, intended to encourage the establishment of new ESVCLPs.

vii Foreign capital gains tax (CGT) regime

From 1 July 2016, a non-final withholding tax regime was introduced to the foreign resident CGT regime. Generally, if a non-resident disposes of a specific interest, the purchaser will...
have to withhold and remit 10 per cent of the proceeds to the ATO. This will not only apply to capital gains, but also where the disposal of the asset is likely to generate gains on revenue accounts.

**IV OUTLOOK**

Aside from the continued tinkering with Australian tax laws as they affect PE and the significant investor visa regime, another significant development is the increasing regulation of foreign investment in Australia. Sovereign wealth funds and public pension funds are a significant source of capital for PE funds in Australia. However, each of these is considered to be a ‘foreign government investor’ for purposes of Australia’s foreign investment rules. If foreign government investors from one country comprise 20 per cent or more of an Australian-domiciled PE fund, or foreign government investors from multiple countries comprise 40 per cent or more of an Australian domiciled PE fund, the fund itself (and ultimately its investees) will be considered to be a foreign government investor – meaning that virtually all of its investments in Australia (and the downstream acquisitions by its investees) will be subject to Australia’s foreign investment approval regime. Foreign investment applications now attract fees, which in the case of business acquisitions range from A$25,300 to A$101,500 depending on the value of the acquisition. While this added regulatory burden does not appear to have dampened fundraising, it has increased the cost of doing business in Australia for PE funds. The government is currently consulting on reforms aimed at alleviating this issue.

The government also intends to use the foreign investment review process to review tax structuring more closely, particularly for acquisitions by PE funds.
Chapter 2

AUSTRIA

Martin Abram and Clemens Philipp Schindler¹

I GENERAL OVERVIEW

At the time of writing, no information was available about the fundraising market in 2016. According to the Austrian Venture Capital Association, Austrian private equity and venture capital funds raised €111 million in 2015, 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, in particular due to the increased administrative burden on funds under the Austrian Alternative Investment Fund Manager Act (AIFMG), which implements the AIFM Directive.²

In July 2016, the Austrian government announced plans to implement a ‘start-up’ initiative, which was said to include a grant programme for early-stage investors and the reintroduction of the medium-sized business financing company (which provides tax benefits for investors).

II LEGAL FRAMEWORK FOR FUNDRAISING

Since the introduction of the AIFMG, 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 a 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 needs to be registered with the FMA. AIFMs need to obtain a licence if they manage funds with assets of more than €100 million (where leverage is used) or more than €500 million (where no leverage is used); otherwise, only a registration is required.

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

a licensed AIFM needs to 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 needs to 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 need to be sufficiently experienced, and have to pass a ‘fit and proper’ test of the FMA if so requested;

b the AIFM has to appoint at least two individual persons as its managers; and

c in the application to the FMA, the AIFM needs to 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 after the applicant has provided 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 needs to 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 fulfill 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. Currently, there is no such preferential regime available for new investments, although the Austrian government has announced last year to reintroduce the MFG as part of its ‘Start-up’ package.

### Key legal terms

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

- **a** investment restrictions, such as target size, concentration limits, geographic limitations, diversification of industries, limits on borrowing and related-party transaction restrictions;
- **b** limitations on the fund’s size and the investors’ capital commitments;
- **c** investment period;
- **d** key-man provisions;
- **e** provisions permitting the removal of the manager by a qualified majority of investors;
- **f** remuneration of the manager (i.e., management fee, investment-related fees and carried interest);
- **g** reinvestments; and
- **h** exclusivity.

### 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 need 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 also needs to be taken to ensure that the wording of the 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.

iv Solicitation

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

Limitations on solicitation

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

For AIFs managed by a licensed AIFM:

- interests in the fund may only be offered or sold after the AIF is approved by the FMA; and
- interests in the fund may be offered or sold to private investors, if the prerequisites of Sections 48 and 49 AIFMG are met, except if the fund is registered (1) as a European venture capital fund (EuVECA) (see 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 such 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 less 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\(^3\)

The EuVECA Regulation was introduced to create a new pan-European designation for small AIFMs, the EuVECA. Austrian-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\(^4\)

The ELTIF Regulation was introduced in November 2015 to channel capital raised through AIFs towards European long-term investments in the real economy. Austrian-based AIF 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 forth in the ELTIF Regulation and submit an application to the FMA. The main advantage of such registration is the option to market the relevant AIF throughout the EU under an

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\(^3\) Regulation (EU) 345/2013 on European venture capital funds.

\(^4\) Regulation (EU) 760/2015 on European long-term investment funds.
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 such 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, respectively, the fund vehicle by contractual provisions (e.g., excluding the liability for ‘ordinary negligence’). However, such contractual provision 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 respective AIF.

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 need 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) need to be disclosed to the FMA, but only by licensed AIFMs.

Private equity funds established as AIFs need to 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 respective 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. Capital duty, however, is not levied anymore since 1 January 2016. Another area to consider is stamp duties, 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. If the guarantee, however, 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 such 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).

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) is at least 1 per cent 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) is at least 1 per cent 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 a 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**

In 2015, fundraising by Austrian-based private equity amounted to €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. No information for 2016 has been released yet.

In July 2016, the Austrian government announced plans to implement a ‘start-up’ initiative, which was said to include a grant programme for early-stage investors and the reintroduction of the medium-sized business financing company (which provides tax benefits for investors). As of the beginning of 2017, no steps have, however, been taken in this respect. It remains to be seen whether this initiative (if it is carried through) will have a positive impact on fundraising activities in 2017.

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Chapter 3

BRAZIL

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

I GENERAL OVERVIEW

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

In addition to Brazil’s economic development over this period, such evolution can also be attributed to the improvement of the regulatory structures of our capital market, mainly 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 Commission (CVM) has been constantly concerned in regulating and updating specific rules for such funds, as per the recent issuance of CVM Instruction 578/16, on 30 August 2016, which replaced CVM Instruction 391/03 and modernised the rules regarding the formation, operation and management of private equity funds, as will be further explored.

A study carried out by the Brazilian Private Equity and Venture Capital Association (ABVCAP) found that resources held by local investors increased only 10 per cent in 2015 over 2014, while those held by foreign investors increased by 12 per cent, evidencing still a growing interest in the Brazilian market by local and foreign players, despite the economic and political crisis. In 2016, the Brazilian Federal Police conducted an important investigation on fraudulent investments made by the four largest pension funds in Brazil using FIPs as vehicles of investment.

Despite the political scandals and change of government in 2016, which kept investors uncertain about committing capital in Brazil, significant transactions involving local and foreign private equity funds have occurred, as per the capital injection of US$125 million made by the North American fund Equity International in Estapar Estacionamentos, one of the largest parking infrastructure and service operators in Brazil.

It is also worth mentioning another transaction that took place in 2016 by the North American private equity fund General Atlantic, which increased its stake in Brazilian brokerage firm XP Investimentos from 33 per cent to 49 per cent, for US$130 million, through a capital injection and the acquisition of a 10 per cent stake held by Actis LLC.

1 Marcus Vinicius Bitencourt and Alex Jorge are partners, Renata Amorim and Marcelo Siqueira are senior associates, and Tatiana Martins is associate at Campos Mello Advogados.

Before XP Investimentos, General Atlantic acquired 17 per cent stake in the drugstore chain Pague Menos in the end of 2015, and invested 200 million reais in Ouro Fino Saude Animal Participações SA in 2014.

In the first semester of 2016, ABVCAP coordinated a research project with private equity and venture capital foreign and local investors concerning the challenges and opportunities for investments in Brazil. According to the research, 88 per cent of the foreign investors intend to increase the allocation of private equity or venture capital in Brazil in the next three years. They attribute the leading factors to invest in the Brazilian market to portfolio diversification, qualified managers and lower risk versus return if compared with developed markets.

This scenario means 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.

According to the ranking by the Brazilian Association of Financial and Capital Market Entities (ANBIMA), the portfolio managers responsible for most of the assets until November 2016 were BB DTVM SA, Itaú Unibanco SA and Bradesco.

For 2017, specialists forecast that the conclusion of the former President Dilma Rousseff’s impeachment and the perception of economic and political stability can bolster investor confidence in the Brazilian market. Additionally, the substantial devaluation of the real against the dollar and the material demand for investment into several sectors of the economy, including infrastructure, hospitality, shopping centres, energy, services, technology and internet, healthcare and medical devices, and agribusiness can provide a favourable scenario for private equity investment.

II LEGAL FRAMEWORK FOR FUNDRAISING

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

i Vehicles for fundraising

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

The above-mentioned countries stand out for investments in Brazil, and in most cases such 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.

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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 such investments. The main jurisdictions used for fundraising are those included in the Brazilian ‘grey list’ – countries that grant privileged tax regimes.\(^5\)

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,\(^6\) 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, being required to maintain, at least, 90 per cent of its resources invested in such assets.

FIPs do not have separate legal personality, so the terms of the Brazilian Law of Corporations (Law 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 such owners hold a portion (shares) of the total assets.

It is important to mention that, on 30 August 2016, a new CVM Instruction 578/16 was enacted replacing the CVM Instruction 391/03 and creating new rules concerning the formation, operation and management of FIPs. The new rules brought by such CVM Instruction shall be adopted by the FIPs within 12 months counted from the publication of such rules, or immediately, in case the existing FIPs conduct a public offering of shares (registered or not) after the publication of CVM Instruction 578/16. Furthermore, on the same date, CVM Instruction 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.

\(^5\) Pursuant to the terms of Law 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 of 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).

\(^6\) An important development brought by CVM Instruction 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.
The administration of an FIP comprises all of the services directly or indirectly related to its representation, operation and maintenance, such as portfolio management; investment advising; treasury and share processing control activities; placement of shares; and bookkeeping of the issuance and redemption of shares.

According to the recently enacted CVM Instruction 578/16, the FIP’s administrator may also engage, on behalf of the fund, third parties to render the following services: (1) the 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. Such new 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 FIPs investments. In this regard, according to the CVM Instruction 578/16, the portfolio manager has powers to represent the FIP in certain acts such as (1) negotiation and hiring, on behalf of the fund, of the assets and agents to conduct the FIP’s transactions; (2) to negotiate and hire 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 (3) to monitor the assets of the FIP and to exercise the voting right related to such 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 days, the copies of all documents executed on behalf of the FIP.

It is also worth mentioning that CVM Instruction 558/15, which came into force on 4 January 2016, has brought new rules on the activities related to the securities portfolio administration in general. Among those rules, two categories of registration of portfolio administration have been established, as well as new requirements and procedures related to the registration of such 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, as well as to render securities consulting services; 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 new CVM Instruction mentioned above has also established the possibility of a legal entity that is not a financial institution to require the registration as fiduciary administrator, as long as it continually maintains a minimum capital defined by 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.

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7 Although such instruction was already in force since 4 January 2016, the securities portfolio administrators that had already obtained their registration with CVM before 4 January 2016 had until 30 June 2016 to comply with the new rules brought by CVM Instruction 558/15.

8 According to the CVM Instruction 558/15, the portfolio administrator can request the registration in only one or both categories, being also able to request to CVM the change of its category.
In addition, CVM Instruction 558/15 has established, as a requirement for the granting, to a legal entity, of registration of securities portfolio administration, that such entity appoints a compliance officer responsible for the implementation of the rules set forth by the CVM Instruction 558/15, as well as the procedures, policies and internal controls of the funds, and, specifically for the category of portfolio manager, that the entity also appoints an officer responsible for the risk management (the compliance officer has the possibility to take on this duty as well).

Finally, it is also important to mention that upon the enactment of CVM Instruction 558/15, the securities portfolio administrator that is a legal entity is authorised to carry out the placement of shares issued by the investment funds which are managed by such entity, even if the latter is not a financial institution, and upon the compliance with some requirements established by the CVM.

ii Disclosure of information

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

In line with such duty, the CVM imposes on the administrators, by means of Article 46 of CVM Instruction 578/16, the obligation to periodically present to the CVM information on the accounting and financial status of the client FIPs through an electronic system on its website. The required information is as follows:

a within 15 days after the end of each quarter, the information established in Schedule 46-I of CVM Instruction 578/16 (i.e., name of the FIP and its administrator, net equity of the fund, amount of subscribed capital and paid up shares, number of shareholders per each category, equity held by each of such category, etc.);

b on a semi-annual basis, within 150 days after the end of such period, the portfolio composition, specifying the number and types of securities held;\(^9\) and

c annually, within 150 days of the end of the fiscal (calendar) year, the financial statements for the year with the independent auditor’s opinion and the administrator’s and portfolio manager’s opinion.\(^{10}\)

iii Conduct and governance obligations

As well as the above-mentioned disclosure obligations, Article 16 of the CVM Instruction 558/15 (which revoked CVM Instruction 306/99), provides that the administrator and portfolio manager are subject to the following strict conduct rules in the performance of their duties:

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

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\(^9\) The information mentioned in this item b shall be sent to CVM based on the fiscal year of the FIP.

\(^{10}\) As regards item (b) above, it is important to mention that the recently enacted CVM Instruction 578/16 has waived the necessity of provision of the non-audited financial statements on a semi-annual basis, as provided on CVM Instruction 391/03 (revoked by CVM Instruction 578/16), and has increased from 120 to 150 days the term for the provision of the audited financial statements.
to fulfil duties in such a way as to meet the investment goals of the holder or holders of the portfolio and avoiding practices that could breach their trust;

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

- the investment policy to be adopted;
- the detailed description of the compensation payable in exchange for the services;
- 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 such activities and the management of the portfolio;

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

e to hire custody services or to certify that the securities that are part of the portfolios under management are kept under the custody of a duly accredited entity and to take all actions as may be useful or necessary to protect the interests of its clients;11

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

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

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

i in case of an administrator that is a legal entity, to establish the policy related to the purchase and sale of securities by officers, employees, collaborators, controlling partners, and by the company itself.

It is also worth mentioning that the CVM Instruction 578/16 establishes that, in case the FIP’s administrator hires third parties to render the services of treasury, activities of controlling and processing of portfolio assets or bookkeeping of the issuance or redemption of shares, the services agreement shall contain a provision establishing that the FIP’s administrator and the respective third party is jointly liable for eventual damages caused to the FIP’s shareholders due to 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 renderers of services hired, are liable, before the CVM and in accordance with the respective attribution, for the violation of any law, applicable rulings or the fund’s by-laws.

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. Such

11 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.
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, in case a higher quorum is not established in the FIP’s by-laws.

As regards the requirement of exerting influence on the definition of the strategic policies and management of the investee companies, it does not apply to the investment in companies listed in special trading segments created by stock exchanges or over-the-counter market, destined to access market, which ensures, by means of contractual relation, corporate governance standards stricter than those required by law, provided that such investment corresponds to up to 35 per cent\(^\text{12}\) of the FIP’s subscribed capital.

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

a. prohibition on issuing founders’ shares and the absence of such securities in the market;
b. establishment of a unified term of office of up to two years for all the members of the board of directors, in case such board exists in the company;
c. to make available, to the shareholders, agreements with related parties, shareholders’ agreements and option plans for the acquisition of shares or other securities issued by the investee company;
d. to resolve corporate disputes through arbitration;
e. in the event that the investee company goes public through category A,\(^\text{13}\) it must undertake to the fund to join a special listing segment of a stock exchange or of an organised over-the-counter market management entity that guarantees at least the differentiated levels of corporate governance practices provided in the items above; and
f. an annual audit of its financial statements by an independent auditor registered with the CVM.

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\(^\text{12}\) 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 forth in the instrument of investment commitment. In case the fund supersedes the limit mentioned above (of 35 per cent) due to reasons beyond the control of the portfolio manager, at the end of the respective month and such non-compliance endures until the end of the following month, the FIP’s administrator shall immediately inform CVM about such non-compliance and the related reasons, as well as the expected term for compliance, and inform CVM about the effective compliance, when it occurs.

\(^\text{13}\) Pursuant to CVM Instruction 480/09, the registration of corporations with 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 (a) shares or certificates of share deposits; or (b) securities that grant to its holder the right to acquire the securities mentioned in item (a) as a consequence of its conversion or of the exercise of rights attributed to them, provided that they are issued by the issuer of the securities mentioned in item (a) or by a corporation of the same group of such issuer.
iv  FIPs portfolio

According to the recently enacted CVM Instruction 578/16, the FIPs are classified into one of 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.

Each category of FIP as described above shall be allowed its own investment policy. The seed capital and the emerging companies FIPs, for instance, are now allowed to invest in limited liability companies, which was a significant change brought by CVM Instruction 578/16 if compared to CVM Instruction 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 ended prior to the first payment of the fund, and shall not have presented a revenue greater than such limit in the past three fiscal years. Such corporations and limited liability companies are exempt from the compliance with the corporate governance requirements set forth in CVM Instruction 578/16 (and expressly mentioned in Section II.iii, supra), including from the obligation of providing independent auditing of such companies, however, in case of an increase of the annual gross revenues of the invested companies in such a way that it supersedes the above-mentioned limit, the CVM Instruction 578/16 establishes certain transition rules related to the compliance by such category of FIP with corporate governance requirements.

In addition, and among other rules, such corporations or limited liability companies 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 immediately prior to the first payment of the fund.

Another important development brought by CVM Instruction 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 578/16.14 Multi-strategy FIPs are allowed to combine investments across several categories and may invest up to 100 per cent of their subscribed capital abroad, provided that the by-laws of such FIPs expressly include the possibility of investment in assets abroad as well as the respective percentage of such investment; the by-laws of such FIPs expressly set forth the exclusive participation of professional investors; and the term ‘investment in foreign assets’ is expressly mentioned in the FIP’s name.

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14 According to Article 5 of CVM Instruction 578/16, FIPs shall direct its funds to the purchase of shares, subscription warrants, non-convertible debentures, or other securities convertible into or exchangeable for shares of public or private companies, as well as titles and securities representing equity participation in limited liability companies.
As regards the emerging companies FIPs, they may invest in corporations and limited liability companies with an annual gross revenue of up to 300 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 such limit in the past three fiscal years, and the invested companies are exempt from compliance with some of corporate governance requirements set forth in CVM Instruction 578/16 (discussed in Section II.iii, supra). However, if gross revenue is increased in such a way that it supersedes the above-mentioned limit, some transition rules set forth in CVM Instruction 578/16 shall be complied with.

The Infrastructure FIPs (FIP-IE) and Intensive Economic Production in Research Development and Innovation FIPs (FIP-PD&I) 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 infrastructure projects or intensive economic production in research, development and innovation in Brazil in the energy, transport, water and basic sanitation, irrigation sectors, among other areas deemed as priorities by the federal government. Such categories of FIPs shall have at least five quotaholders, provided that none of them may hold more than 40 per cent of the shares issued by the FIP or earn an amount greater than 40 per cent of the FIPs revenue.

Among the developments brought by CVM Instruction 578/16, it is also important to mention that FIPs are now allowed to advance funds for future capital increases of an invested company, whether private or public corporations, as long as (1) the FIP holds shares of the invested company as of the date of the anticipation of funds; (2) such possibility is expressly set forth in the FIP’s by-laws, including the limit of the subscribed capital that may be subject to the anticipation of funds; (3) the anticipation of funds is irrevocable and the anticipated funds shall be converted into capital; and (4) the advanced funds are converted into capital increase of the invested company within 12 months.

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15 CVM Instruction 578/16, which has created the Emerging Companies FIPs, has revoked CVM Instruction 209/94 which used to set forth 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 reais, as accrued in the fiscal year ended prior to the first payment of the fund. Another difference of the FMIEEs if compared with the FIPs for emerging companies, is that they did not have to comply with the same corporate governance requirements as currently established for the emerging companies FIPs. According to the CVM Instruction 578/16, the FMIEEs shall have a term of (1) 12 months counted from the publication of such instruction; or (2) immediately, in case the existing FMIEEs conduct a public offering of shares (registered or not) after the publication of CVM Instruction 578/16, to be adapted to the rules of emerging companies FIPs.
Offerings

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 6,385/76 (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 400/03, which sets forth 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 in order 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 by the FIP to the CVM together with the intermediary financial institution. Such request shall be accompanied by the documents and information required under CVM Instruction 400/03, so as to allow full disclosure of the information on the offering, such as characteristics, volume and price of the offered shares, and the method and place of issuance.

Among these documents is the prospectus, set forth under Article 38 of Instruction 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

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16 Pursuant to CVM Instruction 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 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.

17 Article 19 of Law 6,385/76 sets forth that ‘no public securities offering shall be distributed in the market without prior registry with the CVM’. 
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 the recently enacted CVM Instruction 578/16 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 forth by CVM Instruction 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 (which definition was already mentioned herein), and that the securities are acquired by no more than 50 of those targeted investors.\(^{18}\) 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 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 of a qualified majority of the investors, to post sureties, guarantees, acceptance, co-obligations or *in rem* guarantees (collaterals). Such provision was initially included in CVM Instruction 391/03 (by means of the enactment of CVM Instruction 535/13) and kept in the wording of CVM Instruction 578/16 (which revoked CVM Instruction 391/03),\(^{19}\) and has as one of its goals the increase of the participation of FIPs in leveraged buyouts.

Finally, it is also worth mentioning the development of equity crowdfunding regulation in Brazil, which is currently under discussion before the CVM. The main goal of the equity crowdfunding, by means of online platforms, is to give access to the investors to invest in start-up companies, which still suffer the shortage of resources, especially considering the current economic crisis in Brazil. The expected regulation of equity crowdfunding by the CVM shall set forth clearer rules, especially duties and obligations, and set limits for

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\(^{18}\) Upon the enactment of CVM Instruction 551, as of 25 September 2014, the limitation of the number of qualified investors that can be pursued was increased from 50 to 75 qualified investors, and the maximum number of securities that can be acquired by qualified investors was increased from 20 to 50. Upon the enactment of CVM Instruction 554/14, the reference to ‘qualified investors’ in Articles 3, I and II of CVM Instruction 476/09 was replaced by ‘professional investors’.

\(^{19}\) CVM Instruction 578/16 kept the wording of CVM Instruction 391/03 related to the possibility of granting guarantees by the FIPs, upon the approval of the shareholders’ meeting, and included *in rem* guarantees (collaterals) in the list of guarantees.
the exemption from registration of the public offerings, which are currently linked to the company size and have a maximum amount of funding per year, according to the provisions of CVM Instruction 400/03.

Despite the lack of specific regulation, the issuance of securities by means of equity crowdfunding in Brazil is already permitted and has been carried out by some start-ups upon the application of CVM Instruction 400/03, which allows the public offering of securities issued by small-sized companies in Brazil (MEs and EPPs)\textsuperscript{20} to be carried out without registration. However, crowdfunding is not yet common practice in Brazil mainly because of the legal uncertainty. Due to the lack of regulation by the CVM and the current economic and political crisis, investors are still sceptical about taking such risks.

In this regard, the CVM has issued the public hearing to discuss the above-mentioned regulation with a term until 6 December 2016 to receive comments by the public on the suggested regulation, and such comments are currently under analysis by the CVM.

\section*{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 such law.

In this way, without prejudice to the above-mentioned registration procedures for public offerings, and pursuant to Articles 2 of CVM Instruction 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:

\begin{itemize}
  \item[a] incorporation documents and the full text of the by-laws, with a certificate proving its registration with a registry of instruments and documents;
  \item[b] the administrator’s statement that it has executed the applicable agreements whenever the FIP’s administrator hires, on behalf of the FIP, third parties to render the services set forth in Article 33 Paragraph 2\textsuperscript{21} of CVM Instruction 578/16, and that such agreements are available to CVM;
  \item[c] a statement specifying the name of the independent auditor;
\end{itemize}

\textsuperscript{20} According to the Brazilian Law LC No. 123106, as recently amended by the Brazilian Law LC No. 155106, an ME (<em>microempresa</em>) is considered a company (under the types established in such law or a businessperson) which has in each fiscal year, a gross revenue equal to or lower than 360,000 reais, and an EPP (<em>empresa de pequeno porte</em>) is considered a company (under the types established in such law or a businessperson) that has a gross revenue greater than 360,000 reais and equal to or lower than 4.8 million reais in each fiscal year. In addition, the recently enacted Brazilian Law No. 155/16 has created the possibility of ‘angel investors’ whether individuals or legal entities, to invest in MEs and EPPs without having to hold equity in such 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.

\textsuperscript{21} According to Article 33, Paragraph 2 of CVM Instruction 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.
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; marketing material used in the placement of the fund’s shares, including the prospectus, if any; any additional information that may be provided to potential investors; and the number of the FIP’s enrolment with the Brazilian Taxpayer’s Registry (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 (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:

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;

promote the standardisation of FIPs’ (and other investment vehicles) practices and procedures;

promote FIPs’ (and other investment vehicles) credibility and adequate functioning;

maintain the highest ethical standards and consolidate the institutionalisation of fair practices;

raise the fiduciary standards and promote best practices; and

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 4,131/62 must be observed regarding the definition of ‘foreign capital’ and inflow of funds directly into Brazil, and the terms of the National Monetary Council (CMN) Resolution 4,373/14 must also be observed whenever such funds enter Brazil through the capital market.22

In cases of direct investment, every foreign investor and every Brazilian company in which such 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.

Investments made in the Brazilian financial and capital markets through CMN Resolution 4,373/14 are subject to favourable income tax treatment. Concerning FIPs specifically, the income arising from investment in such funds and gains arising from the sale

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22 Pursuant to Article 1 of CMN Resolution 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 such 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.
or amortisation of FIP quotas by non-resident investors that are not resident or domiciled in a favourable tax jurisdiction\(^{23}\) are currently taxed at zero per cent, provided the following requirements are met (the FIP Requirements):

\(a\) the non-resident investor does not hold, individually or with related parties (as defined by applicable legislation\(^{24}\)), 40 per cent or more of all shares issued by the fund (shareholding test) or does not have the right to receive 40 per cent or more of the total income generated by the fund (economic test);\(^{25}\)

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

\(c\) at least 67 per cent of the portfolio is composed of shares of corporations, debentures that are convertible into shares and subscription warrants (allowed assets); and

\(d\) 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 allowed assets.

Additionally, 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):

\(a\) the quotaholders must be exclusively non-residents; and

\(b\) the fund regulations must provide that its fund application is made exclusively in:\(^{26}\)

\(^{23}\) 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 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 such list as being a numerus clausus list, namely, any jurisdiction not appearing on the list will not be deemed as a favourable tax jurisdiction. Ireland was the last inclusion in the end of 2016.

\(^{24}\) Such 40 per cent ceiling considers the following related parties of the investor of the FIP: (a) regarding individuals, (1) its relatives up to the second degree, (2) company controlled by the investor or by any of its relatives up to the second degree and (3) partners or managers of the company controlled by the investor or its relatives up to the second degree; and (b) regarding legal entities, the one which is its controller, controlled or affiliated.

\(^{25}\) 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 such 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.

\(^{26}\) If the fund regulations restrict its quotaholders 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
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 such assets are residents or are domiciled outside Brazil (except if situated in a favourable tax jurisdiction); or
• assets traded in financial and capital markets that are exempt from taxation, provided that they are negotiated by the funds under the same terms and conditions set forth 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, due to 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 a FIP</td>
<td>IOF: zero per cent</td>
<td>Registration of the investor under CMN Resolution 4.373/14. Financial institutions are required to represent the investor and comply with regulatory and tax requirements</td>
</tr>
<tr>
<td>Amortisation or redemption of FIP shares</td>
<td>IOF: zero per cent, Withholding capital gains tax (WHT): in general, progressive table from 15 per cent and 22.5 per cent; but zero per cent if certain FIP requirements are met</td>
<td>Capital gain is the difference of the amortised value and the corresponding cost of the shares amortised (calculated in Brazilian reais)</td>
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<tr>
<td>Sale of shares</td>
<td>IOF: zero per cent, WHT capital gains: in general progressive table from 15 per cent and 22.5 per cent, but zero percent if certain FIP requirements are met</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>Dividends from lower tier companies held by the FIP</td>
<td>IOF: zero per cent, WHT: exemption (but taxed when further distributed to the FIP holders as WHT capital gains)</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 has sought taxation of these dividends as an amortisation or redemption of FIP shares.</td>
</tr>
</tbody>
</table>

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). The government tried to increase the tax rate of ‘interest on stockholders’ equity’ to 18 per cent through a provisional measure, but the Congress did not approve it in due time, with the tax rate being kept at 15 per cent.

1 If the FIP does not follow the investment requirements established by the CVM and at least 67 per cent of its net worth refers to shares, convertible debentures or subscription bonuses, then the applicable tax rates range between 15 and 22.5 per cent. If only those requirements are met, the tax rate is 15 per cent. If the FIP requirements are met, the tax rate is zero per cent.
2 Same as above.
3 Since 2017, in 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 million 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 13,259/2016).

11,033/2004 (e.g., certificates of real estate receivables (CRIs), real estate investment funds (FIIs)).
IV  OUTLOOK

There are certain difficulties in bringing fundraising into Brazil when compared with the existing offshore fundraising possibilities. This is largely due to 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 476/09. As previously mentioned, the CVM has amended this regulation in order 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, the CVM has amended CVM Instruction 409/04\(^\text{27}\) (which was, afterwards, revoked by CVM Instruction 555/14, as mentioned below, and created 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 the CVM Instruction 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.

Such CVM Instruction also allows FMAs, when incorporated as closed funds, to invest up to one-third of their net assets in shares, debentures, subscription bonus, or other titles or securities convertible into shares issued by closely held companies, provided that they participate in the decision process of the investee companies, and that such closely held companies adopt some corporate governance practices as established in the CVM Instruction 555/14.

Another important amendment to CVM Instruction 409/04 (which was kept by the CVM Instruction 555/14, that replaced CVM Instruction 409/04) has created rules to enable investment in companies with lower liquidity, authorising FMAs,\(^\text{28}\) 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 (1) the repurchase price is lower than the book value of the share as of the day immediately prior to the repurchase, (2) the repurchased shares are cancelled; and (3) 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.

\(^{27}\) Such amendments were made by the enactment of CVM Instruction 549 as of 24 June 2014.

\(^{28}\) The provisions related to the FMA mentioned herein have remained in force under CVM Instruction 555/14, which came into force on 1 October 2015.
As mentioned above, on 17 December 2014, the CVM enacted CVM Instruction 555/14, which has replaced CVM Instruction 409/04 on 1 October 2015, establishing new provisions on the investment funds.

Amendments brought about by CVM Instruction 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, the new CVM Instruction has set forth provisions on the following:

- 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;
- a prohibition on receiving remuneration that threatens the independence of a fund’s portfolio management;
- additional transparency in relation to the distribution policy;
- 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 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 is 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 the recently enacted CVM Instruction 578/16, which, as mentioned above, replaced CVM Instruction 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 companies FIPs, which are allowed to invest in limited liability companies. The creation of such types of FIPs represents 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 its portfolio in foreign assets, provided that such foreign assets have the same economic nature of the assets permitted to be invested by the 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 some other requirements are complied with (as mentioned in Section II.iv, supra).

Another important development brought by CVM Instruction 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 FIPs assets. Such loans may now also be used for the payment of pending shares subscribed and not paid by the shareholders.

Furthermore, such CVM Instruction now allows the FIPs exclusively destined to professional investors to have classes of shares with different political and economic rights (in addition to those rights already established in Article 19, Section 29 of CVM Instruction

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29 According to Article 19, Paragraph 2 of CVM Instruction 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
Brazil

578/16 also enables the establishment of different investment conditions for each class of shares. 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 possibility of the FIPs granting guarantees (initially brought by the enactment of CVM Instruction 535/13, which amended CVM Instruction 391/03, and kept by CVM Instruction 578/16 that revoked CVM Instruction 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 and other development banks to become more involved in the expansion of local industry. As previously mentioned, this would facilitate the use of leveraged buyout mechanisms, however, due to the current scenario of economic crisis, Brazilian banks are not demonstrating an appetite to provide financing for leveraged buyouts. On the other hand, in periods of recession, new opportunities may arise and investment banks may gather forces with controlling shareholders or strategic investors to advance this type of transaction.

The worsening of the political and economic crisis in Brazil, which culminated in the devaluation of the Brazilian real, along with the capital markets slowdown that reduced IPOs, influenced private equity investors to postpone their exit process. Compared to 2015, which was a year of political instability due to several political scandals, which culminated with the president’s impeachment in August 2016, this year has shown that the capital markets slowdown will continue longer than expected.

Despite the current economic, political and financial crisis in Brazil, as well as a continued tax increases, which has already caused a decrease in the growth of investments from local players, we believe that the market is still promising for local and global players, especially considering the recent 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 is currently under analysis by CVM, as well as exchange rates that are favourable to foreign investors and that also creates a favourable scenario for exporting Brazilian products. In addition, due to 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.

Furthermore, there is still a material demand for investment into several sectors of the economy, including infrastructure, hospitality, shopping centres, energy, services, technology and the internet, healthcare and medical devices, and agribusiness. Due to the recent relaxation of Brazilian regulation of the healthcare system, in particular allowing foreign investment, there has been an increase in private equity fund investments in this sector, 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. Finally, the investment in start-up companies (mainly focused in internet and technology sectors), have also been attracting the interest of foreign investors, especially through alternative fundraising mechanisms such as equity crowdfunding.

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.
Chapter 4

CANADA

Jonathan McCullough, James Beeby and Lisa Andrews

I GENERAL OVERVIEW

Capital raising by Canadian private equity funds continued to slow in 2016, with private equity funds raising C$4.7 billion in the first nine months of 2016, which represents only 75 per cent of the C$6.2 billion raised during the same period in 2015. This decline continues the trend that started in 2015 that saw an overall decrease in the total fundraising activity compared with 2014 and 2013. The C$4.7 billion raised by private equity funds in the first nine months of 2016 represents only 55 per cent of the C$14.4 billion raised in all of 2014 and only 29 per cent of the C$16.1 billion raised in all of 2013, a record-breaking year.4, 5, 6

Reflecting the fundraising slowdown in 2016, deal-making activity in Canada's buyout and related private equity market showed a marked decline during the first nine months of 2016.7 As of 30 September 2016, disclosed values of transactions, including both announced and completed transactions, was C$14.3 billion, a decrease of 26 per cent over the same period in 2015.8 In addition to the decrease in deal size, the overall number of deals completed in the first nine months of 2016 was only 229, representing a 27 per cent decrease over the same period in 2015 and the fewest number of deals over the first three-quarters of a year since 2010.9

Canadian buyout and related private equity funds were less active in international transactions than they were in 2015, although 2016 was still the second-strongest year-to-date for Canadian private equity funds investing abroad.10 Canadian funds led or participated

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1 Jonathan McCullough is a founding partner, James Beeby is a partner and Lisa Andrews is an associate at McCullough O’Connor Irwin LLP.
2 All figures in Canadian dollars unless otherwise specified.
8 Ibid.
in a total of 83 deals totalling C$70 billion, including Canadian and non-Canadian investors in the first nine months of 2016. In the same period in 2015, Canadian funds led or participated in 109 deals totalling C$108 billion.

Overall, in 2016 private equity investments were strong in the Canadian information technology and healthcare sectors, more or less on pace with the last few years in the material and resource sectors and very slow in the energy sector. The energy sector saw 18 deals close by the end of October 2016 with a value of C$3.1 billion compared to 36 deals closed with a value of C$7.1 billion in all of 2015. In addition, approximately 47 per cent of Canadian private equity transactions through the end of October 2016 were valued below C$25 million in size with business to business garnering nearly 40 per cent of all activity.

Canadian private equity funds are typically international in the scope of their fundraising efforts. According to a report published in June 2013 by Canada’s Venture Capital and Private Equity Association (CVCA) of the money invested into Canadian private equity funds during that year, North American investors were responsible for 37 per cent, European investors were responsible for a further 37 per cent, Asia-Pacific investors were responsible for 12 per cent, and 14 per cent was attributed to a combination of other countries or regions.

In contrast to the performance of the Canadian private equity market as a whole, the Canadian venture capital market had a record-setting 2016. In 2016, 25 Canadian venture capital funds raised more than C$2.2 billion in committed capital, which is up 86 per cent from the C$1.2 billion raised in 2015 and is likely the highest fundraising levels in Canada since 2002, when C$2.5 billion was raised. In addition, C$2.5 billion was invested in 446 deals in the first nine months of 2016, which was the best first three-quarters of a year since 2001 and the largest number of deals completed in that time period since 2005. The information technology sector in Canada received the majority of the invested funds with 62 per cent of investments totals in the first nine months of 2016 with venture capital dealmaking spread across the country.

i The Canadian market

The Canadian market for investment into private equity funds continues to be extremely concentrated and is dominated by a handful of institutional investors. These include Canada Pension Plan Investment Board (CPPIB), Ontario Teachers’ Pension Plan Board (OTPP), the Caisse de Depot, Public Sector Pension Investment Board (PSP), Ontario Municipal Employees Retirement System, Alberta Investment Management Corporation and British Columbia Investment Management Corporation (bcIMC). These institutions have mature and sophisticated private equity investment programmes with the internal resources to pursue a direct investment strategy. Canadian institutional investors, led by those mentioned

11 Ibid.
12 Ibid.
16 Ibid.
18 Ibid.
above, are continuing to deploy greater shares of their private asset allocations to direct investments, participating in transactions as co-investors or as part of syndicates, rather than as limited partners in managed funds. Canadian institutional investors in 2016 continued this trend of shifting allocations away from managed funds in favour of direct investment and co-investments with private equity managers and accordingly are investing with a smaller group of fund managers. Fund sponsors should be aware that often a key consideration for larger Canadian institutions in choosing which manager to back is the ability of the manager to provide co-investment or direct investment opportunities.

In addition to partnering with fund sponsors, these investors are increasingly partnering with each other in transactions. Examples include investments by CPPIB and OTPP in the Arco Norte toll roads in Mexico, PSP and the Caisse de Depot in global consulting business, Alix Partners and CPPIB and bCIMC along with others in Asciano, a ports, railroad and logistics enterprise in Australia.

Co-investment is seen as a way to access a greater share of attractive investment opportunities as well as a way to reduce the aggregate management fee and carried interest paid to the fund manager. Most co-investment opportunities are offered on a ‘no-fee, no-carry’ basis, or with a reduced fee or carried interest.

Increasingly, we are seeing sponsors using the potential for co-investment as a way of attracting fund commitments. Sponsors are tying co-investment opportunities to a requirement to make a fund investment and blending fund and co-investment management fee and carried interest terms so that investors can effectively reduce the standard ‘2 and 20’ compensation model.

ii Trends in investment strategy

In recent years, Canadian institutional investors have focused increasingly on investments in ‘real assets’: infrastructure and real estate. In an uncertain global financial environment, these investments offer long-term, stable returns that better match the needs of pension beneficiaries.

The Canadian private equity marketplace has over recent years become more competitive and is increasingly efficient. Many attribute the decline in deal activity in 2016, despite record levels of available ‘dry powder’ or capital for investment, to the fact that many of the larger and mid-market opportunities are fully valued through robust auction processes. In this environment, some fund sponsors have adopted a platform strategy – acquiring a company in a particular industry with the intention of acquiring a number of smaller add-on businesses in the same industry that, because of their size, are not as efficiently priced.

Canadian institutional investors had all but abandoned the venture capital asset class due primarily to a long period of disappointing returns and in response, both the federal and several provincial governments stepped in. As a result of the programmes established by the federal and provincial governments, particularly the Venture Capital Action Plan (VCAP), which is described more below, in 2016 institutions once again began investing in venture capital funds such as Georgian Partners, which raised C$485 million, twice the size of its predecessor fund, Relay Ventures, which raised C$200 million and iNovia Capital, which raised C$175 in its fourth early-stage information technology fund.19

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On 14 January 2013 the former Prime Minister of Canada announced the federal government’s VCAP which is a C$400 million initiative designed to ‘increase private sector investments in early-stage risk capital and to support the creation of large-scale venture capital funds led by the private sector.’20 The federal government, in partnership with private sector investors and the governments of Ontario and Quebec, has created four private sector-led venture capital funds of funds: (1) Northleaf Venture Catalyst Fund which is managing C$300 million; (2) Teralys Capital Innovation Fund which is managing C$375 million; (3) Kensington Venture Fund which is managing C$306 million; and (4) HarbourVest Canada Growth Fund which is managing C$375 million.21 Of the C$1.356 billion committed, private sector investors have committed a total of C$904 million, the federal government has committed C$339.5 million and provincial governments have committed C$112.5 million.22 In addition, the federal government has invested a total of C$50 million in four high-performing funds focused on investment opportunities in the life sciences and information and communication technologies sectors: Lumira Capital II, Real Ventures Fund III, CTI Life Sciences Fund II and Relay Ventures III.23

In October 2015, a federal election was held and a federal Liberal government was elected, replacing the federal Conservative government which had formed the federal government for the previous nine years. The Liberal government has renewed its support of the VCAP as part of its Innovation Agenda.24

The Immigrant Investor Venture Capital Program, which was announced by the former federal government on 16 December 2014, has been cancelled by the federal government due to lack of interest.

The current federal government reintroduced the federal portion of the labour-sponsored venture capital corporation tax credits (LSVCC) in the 2016 budget which had been phased out starting in 2015 by the former federal government.25, 26 The proposed LSVCC will permit individual taxpayers to claim a 15 per cent federal tax credit in respect of the ‘net cost’ of an ‘approved share’ of an LSVCC.27

In addition to the federal government, several provincial governments have also launched initiatives to promote venture capital investment in their respective provinces. The provincial government of British Columbia established the BC Renaissance Capital Fund Ltd (BCRCF) in 2008 as a fund of funds to promote venture capital investment in four key technology sectors, namely, digital media, information technology, life sciences and cleantech.28 The BCRCF has committed a total of C$90 million to eight fund managers which have, together with co-invest partners, invested C$385 million in 34 British Columbia companies.29 As a successor to the BCRCF, the government of British Columbia launched

20 The Prime Minister of Canada: www.pm.gc.ca/eng/node/21985.
22 Ibid.
23 Ibid.
26 Canada Revenue Agency: www.cra-arc.gc.ca/gncy/bdgt/2013/q03-eng.html.
29 Ibid.
the C$100 million BC Tech Fund in October 2016, which is a fund of funds managed by Kensington Capital Advisors Inc and which also will make direct investments targeted in the technology sector, including digital media, information communications technology, life sciences and healthcare, and clean technology.30

The provincial government of Alberta established the Alberta Enterprise Corporation to promote the development of a local venture capital industry in their province. To date, Alberta Enterprise Corporation has committed a total of C$105 million to nine venture funds.31 The government of Alberta has agreed to provide an additional C$75 million in funding to the Alberta Enterprise Corporation with C$25 million of funds available in 2015–2016 and C$50 million of funds available in 2016–2017.32

The provincial government of Ontario, in collaboration with several institutional investors, launched a C$205 million fund known as the Ontario Venture Capital Fund (OVCF) which closed in 2008 and is structured as a fund of funds.33 The provincial government of Ontario has also committed up to C$50 million to the Northleaf Venture Capital Fund jointly with the federal government under the VCAP.

### iii Investor cooperation

An interesting feature of the Canadian market is the relatively high degree of cooperation among institutional investors, particularly the smaller and more nimble institutions. This is likely due to the concentration in the market, which results in many of the same investors pursuing the same opportunities, the maturity and sophistication of the investment programmes and relative freedom from the types of prescriptive investment restrictions often faced by pension plans and other institutional investors in other jurisdictions. This cooperation includes sharing investment opportunities and due diligence, jointly engaging advisers and in some cases aggregating commitments to meet minimum investment thresholds for such rights as advisory committee and co-investment participation.

### iv Current limited partner considerations and concerns

While the foremost considerations in fund selection are whether the fund fits within the investment strategy and allocations of the investor (buyout, mezzanine, distressed, infrastructure, growth, geographical and sector focus and the like) and the track record of the investment team, Canadian investors voice a number of common considerations in making fund investment decisions. Some of these are discussed below.

**Alignment of interests**

The focus on alignment of interests extends beyond a consideration of the amount of the general partner’s capital commitment to the fund, to such matters as entitlement to portfolio company fees (with a 100 per cent set-off now market), indemnification, standard of care and fiduciary duty and treatment of conflicts of interest.

30 BC News.
32 Ibid.
**ILPA Compliance**

Canadian institutional investors have embraced the Institutional Limited Partner Association (ILPA) principles and generally will expect that reporting, capital calls and distribution notices will comply with the ILPA templates, and that governance and other terms will meet the ILPA guidelines or that there is a satisfactory explanation as to why they do not. Several investors use the ILPA scorecard as part of the due diligence process.

**Expense shifting and hidden revenues**

Canadian limited partners are increasingly alert to practices where portfolio companies pay fees to affiliates (such as on co-investments which are not subject to the management fee offset) or employ senior advisers associated with the sponsor or outsource management functions at the expense of the limited partnership. Additionally, the US Securities and Exchange Commission has been requiring managers registered under the Investors Advisors Act of 1940 to provide detailed disclosure of expenses that are being charged to the partnership and, for the first time, investors are seeing that some ‘grey area’ expenses that they had assumed were for the manager’s account are being charged to the fund. These include expenses such as industry conferences, access to databases, promotion and the manager’s own registration and compliance fees.

## II LEGAL FRAMEWORK FOR FUNDRAISING

### i Preferred vehicle for private funds

The structure used in Canada almost exclusively as a vehicle for private funds is the limited partnership. Limited partnerships are governed by provincial law and may be formed under the laws of most provinces in Canada. Investors in a limited partnership are afforded limited liability so long as they do not actively participate in management of the business, while the general partner (usually a company or another limited partnership) is subject to unlimited liability. It is unusual for Canadian private equity funds to be established using an offshore structure, except where offshore investors participate. Parallel vehicles are often created for non-Canadian investors and Canadian private equity funds may also establish feeder vehicles for certain types of investors, depending on their specific tax characteristics. Limited partnerships are fiscally transparent under Canadian income tax laws. Otherwise, there is generally no difference in treatment for domestic and foreign investors under Canadian law.

### ii Key documents and terms

The relationship between the investor and the general partner in a Canadian private equity fund is primarily governed by a limited partnership agreement, a subscription agreement and often a side letter. The terms of the limited partnership agreement are often the subject of protracted negotiation with key investors. Due to the concentrated nature of the Canadian marketplace, institutional investors are generally able to negotiate more ‘investor-friendly’ terms than may be the case in international funds. As with most jurisdictions, the main negotiated terms in the limited partnership agreement are as follows.
Investment restrictions

It is common for Canadian funds to be subject to significant restrictions on use of capital. These restrictions include concentration limits, geographic requirements, diversification of industries (or restrictions preventing investment in certain industries), limits on borrowing and related-party transaction restrictions;

Distributions and priority payments

Canadian institutional investors generally prefer a ‘European’ style or cumulative distribution waterfall to the ‘deal by deal’ model favoured by US buyout funds. Carried interest typically remains at 20 per cent, although increasingly investors are requiring a split of distributions within the catch-up step of the waterfall. Provisions for the priority payment of distributions and clawback provisions in the event that excess carry is paid to the general partner or investment manager are frequently the subject of negotiations with institutions often pushing for clawbacks to be calculated and paid prior to termination (and sometimes more frequently).

Management fee

The quantum of the management fee is often the focus of negotiation, and some fund sponsors will offer fee discounts to early investors or to investors committing greater amounts of capital. Managers looking for a more tax efficient alternative for payment of management fees will structure the fee as a priority payment through the waterfall. A 100 per cent offset for fees received from portfolio companies is now the standard in Canadian funds.

Advisory board

Canadian partnership agreements typically provide for an advisory board to oversee conflicts of interest, review valuations and to provide approval of other matters specified in the limited partnership agreement. Advisory boards are generally structured so that participation by nominees of an investor does not constitute ‘taking part in the management’ of the fund and therefore does not typically void the limited liability of the investor. It is common for investors to ask for legal opinions from fund counsel to this effect. Canadian common law is less developed on this point than other jurisdictions, and the legislation is antiquated and unclear, making the provision of these opinions a challenge. Some law firms are prepared to provide only heavily qualified reasoned opinions. The limited partnership legislation in Manitoba and Quebec is superior in this regard, in that there should be no loss of limited liability for purely internal participation in the affairs of the limited partnership, such as through voting as a limited partner or being part of an advisory committee.

Key person clause

This clause is intended to ensure that the fund maintains an appropriate level of staffing by key investment professionals on the basis that the investor has hired specific individuals as external managers of the particular investment strategy. The exact number of key persons and requirement for devotion of time will differ from fund to fund and is often the subject of negotiation. Typically, this type of clause will provide that investors’ requirements to fund new investments will automatically be suspended until the key person default has been remedied. Investors will usually continue to be required to fund expenses of the fund and to complete
investments in process and follow-on investments in existing portfolio companies during the suspension period. If the key person default has not been remedied within a set period (usually six to 12 months), it is common for the fund’s investment period to then terminate;

**Investor remedies**

It is common for Canadian limited partnership agreements to include a number of other investor protection rights including provisions allowing for early termination of the investment period or partnership term (both with cause and without cause) and provisions allowing for removal of the general partner or investment manager (both with and without cause). What constitutes ‘cause’ for these purposes is often the subject of negotiation, as is the investor approval level necessary to trigger such clauses. Typically ‘cause’ will include fraud, wilful and material breach of the limited partnership agreement, breach of fiduciary duty, negligence (sometimes but not always limited to gross negligence) and material breach of law. As cause may be difficult to prove, a no-cause removal right may be the only practical means for investors to remove the general partner and is therefore of great importance to investors.

As discussed above, a number of Canadian institutional investors have adopted the ILPA principles as ‘best practices’. Funds attempting to raise commitments from these institutional investors should expect negotiations to match terms to the ILPA recommendations and may be asked to provide a list setting out compliance and non-compliance with these recommendations.

Side letters are common in Canadian private equity funds and serve to fill in some of the gaps in the limited partnership agreement or to provide investor-specific protections. It is standard for side letters to include a ‘most favoured nations’ clause, which may or may not be limited to allowing investors to elect clauses from other side letters based on committed capital.

**iii Registration of advisers and fund managers**

In Canada, any person who is in the business of advising another about the sale or purchase of securities must be registered as an adviser. Accordingly, managers must be registered as advisers (unless there is an applicable exemption). A partner, director or officer of an adviser who advises on securities must also be personally registered as an adviser. Under the laws of certain jurisdictions, only Canadian corporations or partnerships can be registered as advisers. General partners and offshore managers of a private equity fund that are actively involved in managing portfolio investments need not normally be registered in this way.

In Canada, any person who acts as a manager of an investment fund is required to be registered as an investment fund manager. An investment fund is defined as a mutual fund, or a fund whose primary purpose is to invest money, but that is not formed for the purposes of exercising control over or managing an issuer. Most private equity funds seek to exert some degree of control or management over their portfolio companies and are therefore exempt from this requirement. Hedge fund managers, and in some circumstances mezzanine funds, may be required to register as investment fund managers if they are not actively involved in the management of portfolio companies.

**iv Exemptions from registration for offshore sponsors**

There are certain exemptions from the registration requirements for dealers and advisers under Canadian securities laws that apply to ‘international dealers’ and ‘international advisers’ and in respect of dealings with ‘foreign securities’, which are those securities issued by an
issuer incorporated, formed or created under the laws of a foreign jurisdiction or a security issued by a government of a foreign jurisdiction. Offshore sponsors seeking investment from Canadian-based institutions will look to fit within these exemptions rather than register in Canada. An international dealer may, without registering as a dealer under Canadian securities laws, generally (1) trade in a foreign security as long as the trade is with an adviser or dealer registered under Canadian securities laws and the security is a foreign security or debt security for which a prospectus has not been filed with Canadian securities regulators and (2) trade in a foreign security with an investment dealer registered under Canadian securities laws or any security with an investment dealer as long as the investment dealer is purchasing as principal. An international adviser may, without registration as an adviser under Canadian securities laws, generally act as an adviser to a ‘permitted client’ under Canadian securities laws, if the adviser does not advise that client on securities of Canadian issuers, unless providing that advice is incidental to its providing advice on a foreign security.

Both an international dealer and international adviser must meet the following criteria to rely on the international dealer and international adviser exemptions: (1) their head office, principal place of business or company must be located in a foreign jurisdiction; (2) the international dealer or international adviser must be registered under the securities legislation of the foreign jurisdiction in which its head office or principal place of business is located in a category of registration that permits it to carry on the activities in that jurisdiction that registration as a dealer or adviser, as applicable, would permit it to carry on in Canada; (3) the international dealer or international adviser engages in the business of a dealer or adviser, as applicable, in the foreign jurisdiction in which its head office or principal place of business is located; (4) if an international dealer, the person or company is trading as principal or agent for the issuer of the securities, a permitted client, or a person or company that is not a resident of Canada; (5) if an international adviser, as at the end of its most recently completed financial year, not more than 10 per cent of the aggregate consolidated gross revenue of the adviser, its affiliates and its affiliated partnerships was derived from the portfolio management activities of the adviser, its affiliates and its affiliated partnerships in Canada; and (6) the international dealer or international adviser has submitted to the securities regulatory authority a submission to jurisdiction as required under Canadian securities laws. In addition, the international dealer and international adviser must notify the client that, among other things, it is not registered in Canada to make the trade or provide the advice, as applicable, and it must notify the applicable Canadian regulator that it has relied on the exemption.

v Solicitation and prospectus exemptions

The solicitation and sale of interests in a private equity fund is regulated by provincial securities laws in the jurisdiction of residence of the investor as well as any applicable laws in the governing jurisdiction of the fund. Although there are differences in securities legislation applicable in each province, the legislation is generally similar and the discussion below is equally applicable to investors in all provinces.

Under Canadian law, a fund may not issue securities to an investor without either delivering a prospectus (which must be filed and cleared with applicable provincial securities regulators) to investors or relying upon an exemption from the prospectus requirement. Fundraising for private equity funds in Canada (by both domestic and foreign funds) is generally conducted on a private placement basis to qualifying investors on the basis of one or more available prospectus exemptions. The most commonly used prospectus exemptions available in Canada for capital raising permit the issuance of securities to:
Canada

a accredited investors (a class of persons which includes institutional and government investors, high net-worth individuals and corporations); or
b any person, other than an individual, purchasing securities as principal for a purchase price (or a commitment) of at least C$150,000 in cash, on a net present-value basis.

It should be noted that the terms of these prospectus exemptions are currently under review by securities regulatory authorities in Canada in connection with the creation of the Co-operative Capital Markets Regulatory System and the Capital Markets Regulatory Authority, which are discussed in more detail below.

Private equity funds (and any other issuer proceeding by way of private placement) may only solicit expressions of interest from potential investors who qualify under one or more prospectus exemptions. It is common for funds to solicit interest from qualifying persons by way of a private placement memorandum describing the fund and its terms, its investment mandate and its principals and their investing history. The private placement memorandum is not subject to review by securities regulators in Canada but it is required to be filed with regulators in certain provinces. Fund managers should be aware that under the laws of most provinces, where a private placement memorandum or similar disclosure document has been delivered to prospective investors, any misrepresentation of a material fact or failure to state a material fact in that document will give rise to statutory or contractual rights for damages and rescission on the part of investors in those Provinces. It is common for international funds raising commitments in Canada to prepare a Canadian ‘wrap’ describing these rights and other Canadian legal particularities.

Advertising in connection with the sale of securities is strictly controlled under Canadian securities laws. With the exception of government bonds, no general advertising for the sale of securities is permitted over radio or television unless the securities are qualified by a prospectus. Limited advertising can be made to investors where prospectus exemptions are available.

III REGULATORY DEVELOPMENTS

Unlike most developed economies, Canada does not have a national securities regulator. Pursuant to Canada’s Constitution, each province and territory has authority over securities regulation within its respective borders and accordingly, each province has its own set of securities regulations and its own securities regulator, although to a great extent regulations have been harmonised across the various provinces and territories. In recent years, there has been concerted effort on the part of Canada’s federal government to establish a federal securities regulator. In May 2010, the federal government brought before the Supreme Court of Canada (SCC) the issue of whether Canada’s Constitution would allow for the creation by the federal government of a national securities regulator. In December 2011, the SCC ruled against the federal government’s attempt to create a national securities regulator.

As a result of this defeat at the SCC, rather than attempting to impose a national securities regulatory system, the federal government, together with voluntary participation of certain provincial governments, is now working to create a cooperative securities regulator.

34 Reference re Securities Act, 2011 Supreme Court of Canada 66.
in Canada. To that end, the federal government has signed agreements in principle with the provinces of Ontario, British Columbia, New Brunswick, Saskatchewan, Prince Edward Island and the Yukon Territory for the creation of a unified securities regulatory authority.\textsuperscript{36} The federal government and the governments of the participating provinces and territory have collaboratively developed draft legislation for the provincial capital markets and complementary federal legislation and also entered into a memorandum of agreement.\textsuperscript{37}

The drafts of a Provincial Capital Markets Act (PCMA) and a Federal Capital Markets Stability Act (CMSA) which will create the proposed legislative framework for the Co-operative Capital Markets Regulatory System (CMRS) and the Capital Markets Regulatory Authority (CMRA) were released for public comment on 8 September 2014.\textsuperscript{38} The proposed PCMA and the CMSA were generally broadly criticised for the shape of the proposals, lack of consultation and excessive discretionary authority, among other criticisms.\textsuperscript{39}

Consultation drafts of the PCMA and the CMSA and related materials have been published and commented upon. In July 2016, the initial board of directors of the CMRA was announced.\textsuperscript{40} At the same time, it was announced that participating jurisdictions had agreed to use their respective best efforts to enact the uniform PCMA and the CMSA by 30 June 2018, with the CMRA expected to be operational in 2018.\textsuperscript{41}

Although the provinces of Alberta and Quebec have indicated that they will not be participating in CMRS or CMRA, given that the participating provinces and territory collectively make up more than two-thirds of Canada’s capital market, it follows that the CMRS and CMRA will nevertheless carry substantial clout.\textsuperscript{42}

\section*{IV OUTLOOK}

Given that the Economist Intelligence Unit ranked Canada as the No. 1 place to do business in the G7 and the No. 4 best investment location in the world for 2014–2018 (up three places from 2009–2013); the IESE Business School ranked Canada as No. 3 in its 2016 annual ‘Venture Capital and Private Equity Country Attractiveness Index’; and Forbes ranked Canada No. 10 in its list of ‘Best Countries for Business 2016’, there is continued reason to be optimistic about the outlook for the Canadian economy and for Canadian

\textsuperscript{37} Ibid.
\textsuperscript{40} Cooperative Capital Markets Regulatory System: http://ccmr-ocrmc.ca/capital-markets-regulatory-authority-initial-board-directors-new-implementation-timelines-announced/.
private equity in particular.\textsuperscript{43, 44, 45} A weak Canadian dollar, depressed commodity prices and the general Canadian economic outlook will likely have an impact in the near term on fundraising by Canadian private equity funds and on cross-border deal activity. We expect more inbound investments in 2017 from American buyers taking advantage of a strong US dollar and discounted assets.

One notable effect of the incoming US administration is the possible change in the special tax treatment that Canadian public pensions currently enjoy in cross-border transactions with the US. Canadian public pensions are exempt from paying capital gains in the US and are tax exempt in Canada and as a result, they do not pay capital gains taxes in either Canada or the US.\textsuperscript{46} Cross-border investing is therefore advantageous for Canadian public pensions. As the incoming administration has threatened to disrupt trade agreements with Canada, the tax advantage received by Canadian pension plans may be impacted and cross-border private equity reduced in general.\textsuperscript{47}

As noted above, CVCA members noted that European investors were responsible for 37 per cent of the money invested into Canadian private equity funds.\textsuperscript{48} On 26 September 2014 it was announced that Canada and the EU had entered into a Comprehensive Economic and Trade Agreement (CETA), which is expected to, among other things, increase the number of EU companies that ‘will invest in Canada to take advantage of Canada’s preferential access to the United States and other markets, while non-EU companies will invest in Canada to take advantage of [Canada’s] preferential access to both the EU and the United States.’\textsuperscript{49, 50} On 30 October 2016, Canada ratified CETA and the ministers of all 28 European Union Member States have approved it.\textsuperscript{51} The European Parliament must still ratify CETA, at which point it will take effect on a provisional basis. The investment provisions in CETA set out rules as to how investors and their investments must be treated by the host country and provide investors with greater certainty, stability and protection for their investments and to secure access to each other’s respective markets.\textsuperscript{52} Given these facts, it appears that the outlook for investment into Canadian private equity funds from European investors is also very encouraging.

\textsuperscript{44} The IESE Business School – University of Navarra: http://blog.iese.edu/vcpeindex/.
\textsuperscript{45} Forbes: www.forbes.com/best-countries-for-business/list/.
\textsuperscript{47} Ibid.
Chapter 5

CAYMAN ISLANDS

Nicholas Butcher and Iain McMurdo

I GENERAL OVERVIEW

The Cayman Islands (Cayman) are home to a well-established and ever-growing domicile for private equity funds. This can be seen in the statistics issued by the Cayman Islands Registrar of Partnerships. While a Cayman private equity fund can be established as a company, or indeed a trust, the overwhelming majority of Cayman private equity funds are set up as partnerships to mirror the preferred domestic vehicle of choice, in particular, by US managers and sponsors. Specifically, for reasons that are set out later, private equity funds are typically established as exempted limited partnerships (ELPs) in Cayman. At the end of 2016, there was a total of 19,937 ELPs registered in Cayman. This is triple the 2006 number of 6,468.

The years since the 2008 financial crisis have seen impressive numbers of annual partnership registrations. In 2016 the figure stood at 3,356 compared with 3,377 in 2015, 2,893 in 2014, 2,368 in 2013, 2,037 in 2012, 1,897 in 2011 and 1,543 in 2010.

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, the Exempted Limited Partnership Law 2014 (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.

1 Nicholas Butcher and Iain McMurdo are partners at Maples and Calder.
2 As the overwhelming majority of Cayman private equity funds are ELPs, in this chapter we describe the law and practice applicable to ELPs, except where it is also helpful to refer to other structures.
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 – five years ago 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 2016 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 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 in order 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 such LP to be a GP.9 However, all is not lost for an LP who wants to exert internal control on the activities

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3 See, for example, Sections 14 to 19 and Section 37 of the Companies Law (2016 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.
9 Section 20(1) of the ELP Law.
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 (2013 Revision) could apply.11

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

Specific Cayman disclosures that might be expected, in addition to the investment narrative, terms and risk factors, include the legal form (and especially that the fund, if an ELP, does not have separate legal personality) and the exceptions to limited liability described above. Also typically included would be a statement with respect to tax treatment,

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10 Section 34 of the ELP Law.
11 Penal Code (2013 Revision), Sections 247, 248 and 257.
transmission of investor information under regulatory laws (see Section III, infra) 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, infra.

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.’

12 Section 175 of the Companies Law (2016 Revision).
13 Section 38 of the ELP Law.
14 Note that pursuant to Section 183 of the Companies Law (2016 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, wilful 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. 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 ERISA16 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 on 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. 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.

15 Section 19 of the ELP Law.
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 Money Laundering Regulations (2015 Revision).

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 is involved with terrorism or terrorist 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 such knowledge or suspicion to the Financial Reporting Authority of the Cayman Islands, pursuant to the Proceeds of Crime Law (2016 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 (2015 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 Law. In summary, the judgment in *Mercury* appeared to require physical rather than

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18 Ibid; Paragraph 6, Schedule 4.
19 Section 38 of the ELP Law.
20 *R (on the application of Mercury Tax Group Ltd) v. HM Revenue & Customs* [2008] EWHC 2721.
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, a brand new law that 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 contacting 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

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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.
activities are undertaken in the EEA. At the time of writing, the European Securities and 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. In December 2016 Cayman published regulations intended to make key financial laws consistent with the Directive for the purposes of marketing Cayman funds to European investors. The new regulations are expected to come into effect during the course of 2017. ESMA has indicated it will complete its assessment of Cayman following implementation of these measures.

Cayman private equity funds will ordinarily be ‘financial institutions’ for the purposes of the Foreign Account Tax Compliance Act of the United States (US FATCA). The UK equivalent, UK FATCA, will also be relevant, and Cayman has signed a Model 1 Inter-Governmental Agreement with both the United States and the United Kingdom (IGAs). While the effect of the IGAs and supporting regulations published by Cayman in 2014 are to simplify compliance by Cayman private equity funds with those FATCA regimes, Global Intermediary Identification Number registration may be required in the case of US FATCA, and both impose reporting and due diligence obligations.

The Cayman Islands is also an early adopter of the OECD Common Reporting Standard (CRS). Regulations implementing CRS were passed in October 2015 and Cayman issued detailed Guidance Notes on CRS in 2016. The first reporting date to the Cayman Tax Information Authority in respect of reportable accounts under CRS is 31 May 2017.

IV OUTLOOK

It is fair to say that in the first decade of this century we have witnessed a rise in the formation of successor leveraged buyout funds with investment periods becoming shorter as sponsors successfully deployed capital in acquisitions. Since the worldwide financial credit crisis, investment periods are moving 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 (both in terms of fund size and speed to market) has moved back towards historical trends equivalent to 2000 to 2003, but nevertheless managers successfully launch funds, 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 2015 witnessed a record year for the jurisdiction with respect to the number of partnerships formed (3,370 in total). 2016 continued at this pace, falling just shy of this record at 3,277 new formations for the year. This exceeds the numbers formed in any other year, including the banner years of 2007, 2008 and 2014 respectively, and augurs well for the future resurgence of private equity fund formation in the Cayman Islands. There is strong interest from the US 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 US 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 the equivalent UK FATCA with increased reporting requirements being imposed on the Cayman Islands funds with respect to the US FATCA. Following the signing of the inter-governmental agreement (IGA), the Cayman Islands is now dealing with the onward reporting requirements under the US FATCA. We expect many sponsors will outsource to administrators the reporting 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. Likewise, the UK IGA, signed by the Cayman Islands and the UK on 5 November 2013, compels Cayman Islands foreign institutions, inter alia, to report information annually to the Cayman Islands Tax Information Authority on financial accounts that are held by UK persons. Finally, steps to establish the legislative and operational framework to implement the CRS are well under way and we expect the reporting requirements under UK FATCA to be collapsed into CRS in due course as the UK is also a CRS signatory.\(^{23}\)

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 2017 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.

\(^{23}\) The Cayman Tax Information Authority issued a revised version of the Guidance Notes to include UK FATCA in addition to US FATCA.
Chapter 6

CHINA

James Yong Wang

I GENERAL OVERVIEW

After the promulgation of the Interim Measures for the Supervision and Administration of Private Investment Funds (PIF Interim Measures) by China Securities Regulatory Commission (CSRC) on 21 August 2014 and the first year of implementation of 2015, the private equity (PE) and venture capital (VC) industry, especially with respect to the fundraising activities in China, witnessed a sea change in the regulatory landscape with the strict supervision and regulation of China Securities Regulatory Commission (CSRC), the Asset Management Association of China (AMAC), the Administration of Industry and Commerce (AIC) and other relevant authorities. AMAC, the self-regulatory organisation of the fund industry and the registration authority for the filing of private investment funds (PIFs) and the registration of private fund managers in China, issued a series of rules, guidelines and notices regulating the registration of private fund managers and fundraising activities and AIC registration of investment and investment management entities in many cities (e.g., Beijing, Shanghai, Tianjin) were largely suspended in 2016, which had a significant impact on the market participants and fundraising activities. Despite the PRC government’s tightened regulation of the PE/VC industry, however, the industry continued its fairly rapid growth momentum in 2016.

The concept of VC investment was first introduced in China in the late 1980s, and the government began to officially encourage foreign VC firms to invest in China in 1995. From 1995, the Chinese PE market grew at a rapid pace in respect of both fundraising and investments, and the number of PE and VC firms skyrocketed. According to an AMAC report, the self-regulatory organisation of the fund industry in China, by the end of December 2016, a total of 17,433 private fund managers managing 46,505 PIFs have been registered with AMAC with total capital commitments of 10.24 trillion yuan and total capital commitments.
contributions of 7.89 trillion yuan, comparing to 24,054 PIFs filed with AMAC with total capital commitments of 5.07 trillion yuan and total capital contributions of 4.05 trillion yuan as of the end of December 2015. With regard to the fund managers, the number of management companies with an AUM above 10 billion yuan and between 5 and 10 billion yuan is 133 and 157, respectively, compared to 87 and 99 as of the end of December 2015. The government guidance funds mushroomed in 2016. There were only 457 government guidance funds with aggregate target commitments of 1.28 trillion by the end of 2015, while the aggregate disclosed fund size jumped to 3.3 trillion as of September 2016. A relevant development of the domestic securities market is the New Third Board (NTB). Established in 2006, the NTB was discovered by smart private fund managers as a way to tap the public market in recent years, as demonstrated by the NTB listing of the first private equity fund manager Jiuding in April 2014, followed by about 24 other fund managers by February 2016, including CSM, Cowin Capital, Heaven-Sent Capital, Zeshang VC, Bright Stone, China Equity Group, CURA Investment, Eagle Investment, New Margin Capital etc. More than 20 additional fund managers are on the waiting list, including Legend Capital, CITIC Capital, China Soft Capital, etc. As a result of this development, the potential NTB listing became an important consideration in the fund structuring process for an increasing number of private fund managers. Leading NTB-listed private fund managers such as Jiuding and CSM raised brain-numbing amounts of capital through equity and debt offerings on the NTB in 2015, which were used to acquire mutual fund managers, brokerage firms, CTAs, insurance companies and public companies, fundamentally changing the private fund landscape in China. Due to concerns of CSRC over, and the need to investigate, the fundraising and capital deployment plan of NTB-listed private fund managers, CSRC put a temporary hold on the approval of the NTB listing of private fund managers in December 2015 and financial institutions in general in January 2016. The NTB listing of private fund managers was reopened at the end of May 2016 with eight new listing requirements set for private fund managers and one-year rectification period for existing NTB-listed private fund managers. Only a small number of the largest private fund managers in China may be able to meet the new listing requirements. On the IPO side, after domestic IPO was suspended for about four months in 2015, the IPO market made a comeback in 2016 with 247 approved IPOs in the year, and the number is expected to reach 500 in 2017. The first 10 private fund managers authorised to conduct market-making business in NTB were also announced in 13 December 2016.

Prior to 2007, China’s PE and VC market was dominated by offshore PE and VC funds organised in offshore jurisdictions (typically the Cayman Islands). During that period, most foreign PE and VC funds made their investments into offshore holding vehicles of Chinese companies (the restructuring of such Chinese companies to establish offshore holding vehicles for offshore financing and IPO is called the ‘red-chip’ model) and sought lucrative returns through the IPO of such companies on US or other foreign stock exchanges. The red-chip model was dealt a significant blow with the release of Circular 10 by the Ministry

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6 For a more in-depth case study on the NTB-listing of private fund managers, please refer to Han Kun Private Equity Commentary 'Legal Analysis of NTB-Listing of Private Fund Managers', available at www.hankunlaw.com/downloadfile/newsAndInsights/8556712513dac9e9db2c4f7e81b26488.pdf.

7 With an AUM of 21.4 billion yuan, less than 1 per cent of Blackstone's AUM of US$332.7 billion, the NTB-listed Jiuding was valued at 1.025 billion yuan as of 11 December 2015, very close to the market cap of US$185 billion for Blackstone.
of Commerce (MOFCOM) in 2006, which subjected red-chip restructuring to MOFCOM scrutiny, with no approval having been granted to any case to date. While the overseas IPO exit route has not been completely cut off (thanks to creative counsel finding ways to get around Circular 10), the domestic capital market naturally became an increasingly important part of the exit strategy of PE funds, especially as the government launched the Small and Medium-Sized Enterprise Board in 2004, the Growth Enterprise Board in 2009 and NTB in 2012 in an effort to create a more dynamic, multilayered capital market. Another significant step taken by the government to stimulate the growth of the domestic PE market was the revamping of the Partnership Enterprise Law in 2006 to create the new legal form of ‘limited partnership’ (LLP) commonly used by PE and VC funds in the developed world. Following the amendment of such Law, yuan-denominated funds mushroomed.

Due to China’s strict foreign investment regulation and foreign exchange control, and with the increased intensity of competition for deals, offshore funds increasingly find themselves at a significant disadvantage when competing with yuan funds for domestic deals. Many foreign PE and VC sponsors have thus started to incorporate a yuan fund strategy into their overall China strategy, as further described in Section II, infra. At the same time, many Chinese PE and VC sponsors with a successful track record managing yuan funds started to form and manage offshore funds in order to be more nimble when competing for offshore (red-chip) deals.

II  LEGAL FRAMEWORK FOR FUNDRAISING

i   General

PE versus VC

When a fund sponsor embarks on the task of forming a fund in China, one of the first things it needs to determine is whether to form a PE or VC fund. The distinction is not just a difference in terminology; it carries significant ramifications, because PE and VC funds were created by different enabling regulations and were to some extent also regulated differently. VC funds were created by and operate under the regulations of the National Development and Reform Commission (NDRC), historically the principal regulator for the VC industry, while PE funds were created by local (e.g., provincial and municipal) regulations (literally translated from Chinese as ‘equity investment enterprise’ or ‘EIE’, as opposed to ‘venture capital enterprise’ or VCE). PE and VC funds differ in many respects, including required minimum fund size, minimum investor subscription amount, record-filing requirements, capitalisation for its management company (MC), preferential tax policies, subsidies and

8 Note that the label of PE or VC of a particular fund does not necessarily indicate its investment strategy. An early stage venture fund could very well be formed as a PE fund. However, in order to become eligible for preferential tax and other treatments as a VC fund or raise capital from pools of capital administered by the NDRC or its local counterparts, a fund has to be formed as a VC fund and remain in compliance with the relevant NDRC guidelines.

9 The NDRC, for a short period of time, also regulated PE funds through its mandatory national record-filing regulation.

10 Local AICs generally follow the minimum size requirement for VC funds of 30 million yuan. The minimum size for PE funds may vary depending on the specific location of formation of the PE fund, with the typical requirement being 100 million yuan.
other preferential treatments, and investability by certain limited partners (LPs). In fund formation practice, the distinction between PE and VC funds may significantly complicate the structuring process, as discussed later.

The effectiveness of the amended Securities Investment Funds Law, the first national level legislation covering PIFs, on 1 June 2013, and other related regulations may help harmonise the differences in the regulation of PE and VC funds to some extent over time. The PIF Interim Measures are the first national regulation on PIFs generally. It officially brings both PE and VC funds under the supervision of the CSRC and AMAC, and explicitly specifies the registration and record-filing system for PIFs and their managers, defines ‘qualified investors’, and clarifies the private placement activities and disclosure requirements for private fund managers. As part of the amendment to the PRC Company Law, effective as of 1 March 2014, the 20 per cent minimum requirement for the first instalment of registered capital and the previous strict capital contribution schedule for limited liability companies (LLCs) (five years for investment companies and two years for other companies) have been abandoned in favour of a more flexible capital commitment system, which should make it easier for fund managers to structure their general partner (GP) or MC entities. However, VC funds that intend to file with the NDRC and apply for preferential tax treatment are still subject to the previous capital contribution requirements in some cities.

The PIF Interim Measures regulate ‘investment funds established by way of raising capital from investors in a non-public manner within the territory of China’. Substantially all of the AMAC-registered managers and funds are formed in China. Offshore fund managers and offshore funds targeting Chinese investors or conduct fundraising activities in China, or both, are not expressly excluded from the registration and record-filing requirements. However, since AMAC has not yet published specific rules to regulate this area, such offshore fund managers and funds are currently not subject to the registration and filing requirements. For foreign asset managers, it is also important to note that foreign-owned private fund managers may register with AMAC as a private PE/VC fund manager, and since 30 June 2016, they (including wholly/majority foreign-owned private securities fund managers) are also allowed to apply for the AMAC-registration as securities investments managers. Fidelity became the first foreign firm to obtain the AMAC registration on 3 January 2017 as a wholly foreign-owned private securities fund manager.

Out of their desire to insulate the risks of public market turbulence and the PE/VC industry, the CSRC and AMAC are promoting differentiated regulations and supervisions not only for private securities fund managers and PE/VC managers but for PE and VC managers. VC funds may be prohibited from making any public securities investments in the A-share market (although investing in NTB-listed companies is permitted). We shall wait and see if such prohibition and differentiated treatment will be reflected in mandatory rules and regulations down the road.

11 In practice, AMAC may doubt if a MC entity has sufficient funds to support its fundraising or management activities for more than at least half a year if the MC entity’s paid-in capital is no more than 2 million yuan. So now, for purposes of AMAC registration, equity holders of a private fund manager generally need to make capital contributions of at least RMB 2 million.

12 For a more in-depth description of AMAC rules on registration of wholly/majority foreign-owned private securities fund managers, please refer to Han Kun Private Equity Commentary ‘AMAC Opens Registration to Wholly/Majority Foreign Owned Private Securities Fund Managers’, available at www.hankunlaw.com/downloadfile/newsAndInsights/37d511cfe7a26596241aee6d55ac091.pdf (English) and www.hankunlaw.com/downloadfile/newsAndInsights/b621a5c04399896c626c52a44cc2b477.pdf (Chinese).
Registration

AMAC released the Interim Measures on the Administration of Registration of Non-public Investment Fund Managers and Record-filing of Funds (Record-filing Measures), effective as of 7 February 2014, and many related guidance and announcements to further regulate manager registration, disclosure requirements and internal control of fund managers in 2016. Pursuant to the Record-filing Measures and the Announcement on Matters concerning Further Regulating Registration of Privately Offered Fund Managers released by AMAC on 5 February 2016 (Registration Announcement) in PE/VC industry, any private fund manager is required to register with AMAC prior to carrying out any fundraising activities and complete its record-filing with AMAC for the private fund (regardless of whether it is set up as a PE, VC or hedge fund) within 20 working days of the closing of such fund. Senior management of PIF managers is required to obtain fund professional qualification and PIF managers are required to submit legal opinions on a laundry list of items at the time of their initial registration with AMAC or any subsequent material change. Some basic information regarding the fund, such as the name of the fund, date of establishment, major area of investment, fund manager and custodian, is required to be provided to AMAC through its electronic record-filing system. The private fund manager is also required to update information (such as the total amount of commitment and contribution, total number of investors and any change in the fund’s investment focus), in the case of a private securities fund, on a monthly basis, and in the case of a PE/VC fund, on a quarterly basis, and on the manager itself on an annual basis. In addition, fund managers are required to report to AMAC certain significant matters, such as any change in senior management or the controlling shareholder of the private fund manager, merger, division, bankruptcy of the private fund manager, significant amendment to the fund agreement and liquidation of the fund. Further regulations on private funds are also being developed. Although laws and regulations do not prohibit private fund managers from managing PE/VC funds and securities funds, since the launch of a new registration and filing system for private fund managers on 8 September 2016, private fund managers may only be able to choose one of the following: securities fund manager, PE/VC fund manager or other types of fund manager. Thus, in practice, a private fund manager recently registered on the new system may not be able to be classified as both securities and PE/VC fund managers and manage PE/VC and hedge funds at the same time.

In addition to private funds and their fund managers, effective as of 1 February 2015, third-party service providers to which the private fund or its manager outsource services, such as a fund sales agent, transfer agent, valuator, fund administrator and other fund intermediaries, are also required to register with AMAC and be subject to its supervision pursuant to the Guidelines on Fund Business Outsourcing Services (Trial Implementation). As of the date of this writing, registered third-party service providers are generally commercial banks, securities companies and public funds. Moreover, according to the Interim Administrative Provisions on the Operation of the Private Asset Management Business of Securities and Futures Operation Institutions, effective as of 18 July 2016, only securities and futures operation institutions that are allowed to be engaged in the asset management business and private securities investment fund managers having registered with AMAC for more than one year and obtained AMAC membership are qualified third parties to provide investment advice to

13 Application for AMAC membership is a separate process from the registration of private fund managers and subject to different and higher requirements for the applying manager.
securities and futures operation institutions on the private asset management business. The above-mentioned interim administrative provisions applies to private securities investment fund managers on a *mutatis mutandis* basis.

In an effort to demonstrate that the registration system has real teeth, the CSRC and AMAC have also strengthened their self-disciplinary actions and conduct examination and inspection on the registered private fund managers. Several private fund managers and law firms that issued legal opinions for the registration of such private fund managers were sanctioned by AMAC in 2016.

**ii Domestic sponsors and investors**

*General*

PE funds raising capital exclusively from domestic investors may generally be structured as LLPs under the Partnership Enterprise Law or LLCs under the Companies Law and other national and local regulations. While many Chinese LPs, especially state-owned enterprises (SOEs), were (and to some extent still are) more familiar and comfortable with LLCs, LLPs have gradually become the dominant form for PE funds in general in recent years.

Under the Partnership Enterprise Law, an LLP may have up to 50 partners, including at least one GP and one LP. The number of shareholders of an LLC likewise is limited to 50 under the Companies Law. In addition to LLPs and LLCs, PIFs are also allowed to be structured as ‘contractual funds’ that do not have legal personalities and are managed by fund managers through investment management agreements or other similar agreements. Contractual funds have a number of advantages and drawbacks compared to LLPs and LLCs, as further discussed below.

A PIF may be offered through private placement in China to no more than 200 qualified investors in the case of a contractual fund, or 50 qualified investors in the case of an LLP or LLC, each of whom:

- shall make a minimum commitment of 1 million yuan to the fund; and
- is an entity with net assets in excess of 10 million yuan, or a natural person with individual financial assets in excess of 3 million yuan or an average individual annual income in excess of 500,000 yuan for the past three years.

Deviating from the previous private placement practice in China, where most investors only executed an LLP agreement or a simple subscription form, fund managers are now required to use risk surveys to determine the qualification and risk tolerance of their investors, ask investors to complete investor questionnaires and submit asset ownership certificates to identify investors’ qualifications and prepare a written risk disclosure to be signed by investors. This new practice is consistent with the practice common in the Western world.

The PIF Interim Measures have adopted ‘look-through’ rules for the calculation of the number of investors. However, the following investors are deemed qualified investors and not subject to the look-through rule: (1) social security funds, enterprise annuity schemes and other pension funds, charitable funds and other non-profit funds; (2) investment vehicles and asset management schemes (AMSs) that have been duly established and duly

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14 ‘LLP’ is customarily used as the acronym for ‘limited partnership’ to distinguish it from ‘LP’.

15 Those deemed as qualified investors are discussed below.

16 Except for the three categories, private fund managers and their practitioners who invest in the PIFs under their management are deemed as qualified investors but are subject to the look-through rule.
filed with AMAC; and (3) other investors prescribed by the CSRC. PE, VC and hedge funds (whether structured as LLCs, LLPs or contractual funds), AMSs, trust schemes and other similar investment funds and schemes that are filed with AMAC fall within the second category. Thus, fund sponsors may use multi-tiered structures to effectively get around the 50 or 200 investor limitations at the time of formation of the fund, although such structures may still be subject to heightened scrutiny and challenged by CSRC at the time of the IPO of a portfolio company.

Securities companies participate in PE/VC market and engage in private fundraising and PIF management activities through their direct investment subsidiaries and their subordinated institutions. Those PIFs shall be recorded at Securities Association of China (SAC) since 2012. On 13 March 2016, AMAC released a notice requiring that direct investment subsidiaries of securities companies record their direct investment funds on AMAC’s securities company private funds filing system. More and more PIFs are under the regulation and supervision of AMAC.

Contractual funds and other AMSs

Contractual funds and other AMSs issued by registered PIF managers, licensed trust companies, brokerage firms and mutual fund manager subsidiaries have a number of advantages over LLPs and LLCs: (1) the formation and amendment of an AMS are in the hands of the manager and its investors without the need to go through inflexible and cumbersome local Administration of Industry and Commence (AIC) procedures, (2) an AMS is allowed to have up to 200 investors (compared to 50 for an LLP and LLC), a feature particularly appealing to retail funds formed by asset or wealth management firms, and (3) AMSs also have certain tax advantages such as no tax at the AMS level (compared to an LLC), no mandatory withholding requirement on natural person investors (compared to an LLP) and some other tax planning opportunities to bring the tax payment obligations of the fund sponsor and the investors more in line with the economic deal stricken by them. Thus, in addition to hedge fund managers, AMSs, especially contractual funds, are also finding innovative use in the formation of traditional PE and VC funds recently, often in conjunction with an LLP structure.

Adopting an AMS structure has its drawbacks too, the principal one of which is that it will be looked upon unfavourably at the time of IPO of a portfolio company as the regulators tend to view this structure as an easy way to hide the real owners of the IPO candidate company. As of this writing, there has been no disclosed case of a successful IPO of a company in which an AMS is a direct shareholder; however, recently there have been three approved IPO cases where several AMSs formed by subsidiaries of mutual fund management companies are used somewhere up the shareholding chain (through an LLP private fund) and the ultimate beneficiary owners are disclosed in such cases too. Although CSRC has not officially confirmed that an AMS is acceptable in IPO cases, it is still encouraging news to AMSs formed by licensed financial institutions. As for NTB listing, in October 2015, the NTB released a Q&A that for the first time expressly allows AMSs properly registered with AMAC to invest in pre-NTB companies, and the first NTB listing case (Xinlv Gufen) with an AMS shareholder (an AMS fund managed by Founder Fubon Asset Management Co) was successfully approved in late 2015. An AMS is allowed to invest in companies that are already public or NTB-listed, although since October 2015, CSRC requires any investor in a PIPE deal involving an AMS to be looked through to its ultimate beneficial owners for the purpose of counting the number of investors towards the 200-person limit for a non-public offering.
It is also worth noting that unlike other AMSs that are regulated by CSRC and AMAC, trusts are regulated by CBRC and subject to more stringent IPO/NTB listing rules and thus should generally be avoided in any pre-IPO or pre-NTB company. On 14 December 2016, in a breakthrough case, the material asset reorganisation of Ningbo Xinhai Electronic Holding Co (limited by shares) was approved by CSRC, the first back-door listing case where a record filed contractual fund was fully disclosed as a beneficiary owner several layers up from the direct shareholder.

### iii Foreign investors

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

**Foreign-invested venture capital enterprise (FIVCE)**

Before the advent of the 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 (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 an LLC (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 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.

A 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

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17 For a more in-depth discussion of AMSs, please refer to Han Kun Private Equity Commentary ‘Legal Anatomy on Contractual Private Equity Funds’ and ‘Investment by AMSs in Pre-NTB and Pre-IPO Companies’, available at www.hankunlaw.com/downloadfile/newsAndInsights/57905df9ba30dd26ccfd878849fae51e.pdf and www.hankunlaw.com/downloadfile/newsAndInsights/3c666df7508ad3beb50234689e423.pdf (Chinese).

18 For a more in-depth discussion of FIVCEs, please refer to Han Kun Private Equity Commentary ‘Will FIVCE Fade Away – Tax Pass-through Status of FIVCEs Officially Ended’, available at www.hankunlaw.com/downloadfile/newsAndInsights/621f96184cfa880935c7e674f1e3a88c.pdf (English) and www.hankunlaw.com/downloadfile/newsAndInsights/2ac32de1676104cb84c11bf378faa356.pdf (Chinese).
China

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 choose to be a tax pass-through entity like a partnership, in which case the income of the FIVCE will not be taxed at the fund level but will be allocated and directly taxed in the hands of the investors. The tax pass-through treatment, however, was not well understood by many local tax authorities, causing many non-legal-person FIVCEs to not 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. Certain foreign sponsors have decided to dissolve FIVCEs if such funds have not made substantial investments or their investments have not significantly appreciated in value. To the extent that such dissolution or restructuring requires the transfer of investments to an LLP established by the same group of investors, it would unfortunately trigger enterprise income tax (EIT), as it would be unlikely to qualify as a tax-free reorganisation. Other foreign sponsors have been exploring ways to restructure FIVCEs into LLPs without transferring the underlying portfolio interests. However, as there is currently no law or regulation authorising the restructuring of FIVCEs into LLPs, this can only be done on a case-by-case basis (if at all). To our knowledge, so far there has been no successful case of such restructuring.

Qualified foreign limited partner (QFLP) and yuan-QFLP (R-QFLP)

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 State Administration of Industry and Commerce (SAIC) promulgated the Administrative Regulations on the Registration of Foreign-invested Partnership Enterprises in 2010 and Shanghai released trial regulations on its 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 has clear

19 By comparison, certain local authorities (e.g., Tibet, Xinjiang and Shanghai Pudong District) have introduced local regulations permitting the restructuring of an LLC into an LLP, although the success of the implementation of such local regulations varies among different provinces/districts.

20 For a more in-depth discussion of the QFLP/R-QFLP programmes in various cities, please refer to the following issues of Han Kun Private Equity Commentary: for Shanghai QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/c62418c065e436082cfb853a81b127cc.pdf (English) and www.hankunlaw.com/downloadfile/newsAndInsights/2ac6cbbabef9fda11ed07f290a666e.pdf (Chinese); for Beijing QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/7ed1b1ec9375596e67822778d14602b6e.pdf; for Tianjin QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/30061ab3916d999d0b77a781975b5d88.pdf (Chinese); for Shenzhen QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/sandInsights/2f35dd4551b2bc3fb0bce8f372dddc.pdf (Chinese); for comparison of Beijing, Tianjin and Shanghai QFLP programmes (Chinese), www.hankunlaw.com/downloadfile/newsAndInsights/c01e5068177a72e0e4159eadb4e1c3.pdf; and for R-QFLP, www.hankunlaw.com/downloadfile/newsAndInsights/a853cc028c36ccbf1c346031123260d.pdf (Chinese).

21 Beijing, Tianjin, Chongqing and Shenzhen 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.
advantages over the traditional FIVCE or offshore fund model. In particular, in contrast with a FIVCE, which is now subject to a 25 per cent EIT, a QFLP fund as a partnership enjoys tax pass-through treatment at the fund level. Second, an offshore fund needs to go through the time-consuming approval process with the State Administration of Foreign Exchange (SAFE) for each investment, and foreign currency capital may be converted into yuan directly with the custodian bank in a prompt manner (typically about 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 19 in March 2015, 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 convert foreign exchange-registered capital at their discretion and then make equity investments with yuan. Circular 19 is intended to put the rest of the country on the same level playing field as the several QFLP pilot areas. However, the several QFLP pilot areas are still ahead of the rest of the country in terms of the implementation of the QFLP regulations and thus remain the preferred location for foreign PE/VC firms contemplating a QFLP fund formation at this time.

For those fund sponsors that have not managed an onshore fund before, a QFLP fund could also bring certain reputational and other intangible benefits. To date, about 40 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. Due to the PRC government’s encourage of inflow of foreign capital against the backdrop of the foreign exchange imbalance, 2017 should continue to be a favourable year for foreign asset managers desiring to apply for QFLP licences.

Over the past few years, three main models have emerged for QFLP funds: (1) the DLP model, where the foreign fund sponsor sets up a wholly foreign-owned enterprise (WFOE) to act as the GP/MC of a DLP and raises capital solely from domestic investors in yuan (as exemplified by the Blackstone QFLP fund);22 (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 MC 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). For each model, there are different variations, and the QFLP pilot programme is quite flexible in accommodating such variations. QFLP funds and their MCs are required to include ‘equity investment’ and ‘equity investment management’ in their company names and business scope, and thus are PE funds. Sometimes, the foreign sponsor of a QFLP fund also intends to raise capital from capital pools administered by the NDRC or its local counterparts, which is an example of when the incompatibility between the two lines of regulations over PE and VC funds becomes particularly obvious and poses a significant structuring challenge to the fund sponsor and its counsel.

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22 Even though this structure does not involve a foreign LP, the MC and the fund still need to apply for QFLP licences because PRC law would otherwise prohibit the FIE-MC from using its foreign currency-registered capital to make its GP commitment and contribution to the fund.
The nature of a QFLP fund as a domestic or foreign fund is also an important issue. Under PRC law, it is very clear that QFLP funds under models (2) and (3) 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). The nature of a QFLP fund under model (1) above, however, is less than clear. The Shanghai QFLP regulation was designed by the Shanghai Financial Services Office to permit a QFLP fund that raises capital exclusively from Chinese investors in yuan, and whose foreign element is limited to the capital commitment and contribution by the GP (in the form of a WFOE or other FIE) to the fund of up to 5 per cent of the fund size, to be treated as a purely domestic yuan fund free from any foreign investment restrictions. The Blackstone QFLP fund was structured exactly to fit into such exception. However, the hope of domestic treatment was dealt a big blow by 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 need to comply with the Foreign Investment Industries Guidance Catalogue (e.g., with respect to the prohibition against and restrictions on certain industries, even though such 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). Following the NDRC Blackstone reply, new structures have been developed to minimise the adverse impact of such reply on the investment of similarly situated funds.

Another variation of the QFLP fund is the 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. To date, only two R-QFLP funds have been set up in Shanghai.

**Important variation**

It is very common for foreign sponsors to seek to raise capital exclusively from PRC investors in yuan, namely, under model (1) above. To avoid the time-consuming process of applying for a QFLP licence and foreign investment restrictions, it is desirable for such foreign sponsor to set up a pure DLP without any foreign investment restrictions. One way to structure a pure DLP is to use 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-MC. Careful advance legal and tax planning are required to ensure that such contractual arrangements provide effective control over the GP and are enforceable under PRC law, 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.

iv LPs

Compared with the LP market in the developed countries, China's LP market still remains at a primitive stage. Currently, the main LPs for the PE market in China are the National Social Security Fund Council (NSSFC), SOEs, insurance companies, successful entrepreneurs and high net worth individuals, third-party wealth management firms and fund of funds (FoFs). College endowments and foundations are still in their infancy and are not yet major players in the field, and local and corporate pension funds are not yet permitted to invest directly in PE funds.
In comparison with mature PE markets where the GP-LP model is more developed and the boundaries between GP and LP are highly respected, in China such boundaries are less clear. LPs (especially successful entrepreneurs) often desire to get significantly involved in the investment process of the fund by way of a seat on the investment committee or veto rights with respect to investments. Such involvement is risky, as LPs may lose their limited liability protection under PRC law by participating in the investment and management of the fund. However, as there has been no reported case against an overly active LP yet, such risk has not been sufficiently appreciated.

SOEs are a major source of capital for PE funds, and in recent years they have also become active in seeking to act as the GP, either alone or in partnership with other parties. According to a survey conducted by State Asset Regulatory Commission in May 2016, about 50 per cent of the enterprises directly controlled by the central authorities participated in the PE/VC industry. The participation of SOEs as GP or LPs in a fund creates a myriad of issues. For example, SOEs are expressly prohibited from acting as GP under the Chinese Partnership Enterprise Law. It is unclear, however, what constitutes an SOE for the purposes of this prohibition, and different government agencies apply different standards. According to the SAIC definition, SOEs only refer 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. 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 NSSFC upon its IPO. A fund with a significant level of expected SOE participation should determine in advance whether it may be deemed an SOS subject to the mandatory transfer requirements, and the rules for determining such SOS status are less than clear and not consistently applied. If significant state ownership cannot be avoided, provisions should be built into the partnership agreement and other documents to ensure that other non-SOE LPs and the GP will be made whole by the SOE LPs for the impact on their economic interests.

The fast-growing fundraising activities in 2016 benefited from the rapid development of guidance funds and government-sponsored industry investment funds that provide a large amount of capital for PE/VC funds. By the end of 2016, 1,013 yuan FoFs with more than 1.4 trillion yuan under management are active in the PE/VC market in China, among which 66.7 per cent are guidance funds representing 81.4 per cent of the total capital under management.

For first-tier PE/VC sponsors, the deep-pocketed LPs to go after in fundraising in China are the NSSFC and insurance companies. Since May 2008, the NSSFC has been permitted to allocate up to 10 per cent of its assets (the equivalent of about US$278.6 billion (as at the end of 2016)) to domestic PE funds (investments in offshore PE funds are not yet permitted). Chinese insurance companies have also 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, which translates into 1.5 trillion yuan of investible capital for PE funds as of the end of November 2016. 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 last quarter (approximately 300 billion yuan as of the November 2016) in VC funds. By the end of 2015, Chinese insurance companies have invested a total of 198.6 billion yuan in PE funds. PE and VC firms seeking insurance LPs are required to meet two sets of somewhat different criteria.

In addition to being permitted to invest as LPs into PE/VC funds, insurance companies have recently also been allowed to sponsor PE funds as a GP. Everbright Yongming and
Sunshine Insurance have been approved by the China Insurance Regulatory Commission (CIRC) to set up PE funds as a GP in 2015 and more ‘manager licences’ are expected to be issued by CIRC in 2017.23

For most of the fund sponsors, LPs like the NSSFC or insurance companies are beyond their reach. With the rapid growth of high net worth individuals and the wealthy middle class in China, asset and wealth management firms such as trust companies, brokerage firms, mutual fund managers or their subsidiaries and third-party wealth management firms are playing an increasingly important role in the fundraising of PE funds. The involvement of such asset and wealth management firms may significantly complicate the fund formation process, as they are subject to different regulations by different regulators, and requirements for investor suitability are inconsistent across different types of firms. Trust companies are regulated by CBRC as noted earlier, brokerage firms, mutual fund managers and their subsidiaries are regulated by CSRC, while third-party wealth management firms remain largely unregulated.

v Taxation

Tax is critical to the fund structuring process in China, even more so than in other developed countries, as tax rules with respect to PE funds and their partners are less settled and the room for tax planning and the downside for lack of or inappropriate tax planning may be more significant than in more developed countries.

Under PRC tax law, dividend income between two LLCs is exempt from EIT in order to avoid double corporate taxation (inter-LLC dividend exemption). For the same reason, dividend income from a corporate PE 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 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 fund level or at the corporate investor level.

Individual investors, on the other hand, care deeply about the form of the fund. Individual investors are generally subject to individual income tax (IIT) at a rate of 20 per cent with respect to investment returns from the fund.24 Since a fund in the 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 as well as other entity LPs (such as an FoF in LLP form) that are comprised primarily of individual investors.

24 It is clear that dividend income to an individual investor from an LLC fund shall be taxed at a 20 per cent IIT rate. It is less clear whether income from the disposition of portfolio interests received by an LLP fund and allocated to an individual investor is also subject to 20 per cent IIT. A number of provincial regulations provide for 20 per cent IIT on such disposition income from an LLP fund, even though some national tax rules that predated the LLP legislation, read literally, would require such income to be taxed at a progressive rate from 5 to 35 per cent, which is often less favourable to individual investors.
China

The taxation of an FLP, or more specifically, its offshore partners, remains unclear. One school of thought among the PRC 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 shall apply to dividend income from the FLP to an offshore partner, including carried interest to the offshore GP, the WHT of which may be reduced to 5 per cent if the offshore partner is able to avail itself of such reduced WHT pursuant to a tax treaty between China and the jurisdiction of formation of the foreign partner, unless the offshore partner is deemed to have a ‘permanent establishment’ in China, in which case it will be subject to the 25 per cent EIT. This school of thought, however, has not been accepted by PRC tax authorities, and efforts of tax advisors to negotiate and convince local tax bureaus to accept a 10 per cent WHT have had little success to date. In practice, given the lack of clear guidance on the taxation of offshore partners of an FLP (such as a QFLP fund), some local tax bureaus have been requiring a 25 per cent WHT on dividend income before it may be repatriated to its offshore partners (without distinguishing GP or LP).

Corporate VCIEs that are duly registered with the NDRC enjoy special preferential tax treatment. If they hold investments in qualified small or medium-sized companies with a high-tech qualification certificate for a period of at least two years, they are permitted to apply 70 per cent of its total investment amount in such qualified companies to offset their taxable income, with any excess carried forward to subsequent years. In the case of VCIEs formed as LLPs, effectively as of 1 October 2015, the 70 per cent tax benefits may also be passed along to their corporate LPs pursuant to Guoshui (2015) Circular 81. The high-tech qualification certificate, however, is not easy to obtain in practice.

vi Structuring of outbound investment funds

In 2016, China saw huge growth (an increase of 44 per cent) in outbound direct investment (ODI), with a total of over US$170 billion invested outside of China even though the PRC government has significantly tightened the ODI and other outbound investment filing and approval channels due to significant concerns about capital flee and foreign exchange imbalance. Outbound mergers and acquisitions reach a new peak, with a large number of mergers in the manufacturing and information technology industry. The US and Europe face challenges from Chinese investors, and it is said that about 30 transactions worth US$750 billion have been cancelled due to the difficulty in obtaining government approval for ODI, national securities and other sensitive reasons. The devaluation pressure on yuan and the benchmark interest rate cut by the People's Bank of China (PBOC) also underpin the rising need for ODI and international allocation of assets of domestic entities and high net worth individuals. Many domestic PIFs participated in the outbound investment wave, most of which were through the ODI channel. As general ODI filing procedures are complex and time-consuming, many PIF managers establish special purpose LLPs in Free Trade Zones in Shanghai, Tianjin, Qianhai or elsewhere to take advantage of the more convenient and fast ODI filing procedures. In the case of investing in offshore secondary markets or offshore PE/VC funds or hedge funds, the Qualified Domestic Limited Partnership (QDLP) pilot programmes in Shanghai, Tianjin and Qingdao, the Qualified Domestic Investment Enterprise (QDIE) pilot programme in Shenzhen and the Qualified Domestic Institutional Investor programme provide alternative options for managers provided that they shall be qualified and get approvals under relevant programmes. SAFE released Circular Huifa (2017) No. 3 on 26 January 2017, and strengthened the examination of authenticity and compliance of ODI. Supervision of individual foreign exchange businesses has also been reinforced since 1 January 2017.
III REGULATORY DEVELOPMENTS

i Interim measures for the administration of government-sponsored industry investment funds

Recently, NDRC issued the Interim Measures for the Administration of Government-sponsored Industry Investment Funds (Measures for Government Funds), effectively as of 1 April 2017. The Measures for Government Funds, on the basis of a clear definition of ‘government-sponsored industry investment funds’, further provide that government-sponsored industry investment funds may be established in various organisational forms, such as a corporation, partnership and a contractual form, and that a variety of means, such as the equity participation in funds, joint investment, financing guarantee, and a mode under which the governments make capital contributions and surrender appropriate part of profits, can be made use of in an integrated manner to bring the functions of funds into full play. PIFs accepting government investment may not invest more than 20 per cent of their aggregate capital in any single portfolio company and shall make relevant reporting and disclosures on the government-sponsored funds credit information registration system.

ii Management practices for the private investment fund subsidiaries of securities companies and the management practices for the alternative investment subsidiaries of securities companies

In order to improve the self-discipline management systems and prevent systematic risks relating to the mixed operation and competition of subsidiaries of securities companies, on 30 December 2016, SAC promulgate Circular on Issuing the Management Practices for the Private Investment Fund Subsidiaries of Securities Companies and the Management Practices for the Alternative Investment Subsidiaries of Securities Companies. In principle, only one subsidiary can be established to do either PIFs or alternative investment, and relevant subsidiaries shall carry on professional business, and shall not conduct business concurrently. The circulars provide a 12-month rectification period for securities companies. If the existing business of the direct investment or investment management subsidiaries of the securities companies does not meet the requirements herein, they may only continue to operate or manage existing PIFs and may not raise or manage new PIFs or open up existing PIFs for new subscriptions. PE/VC business and fundraising activities of subsidiaries of securities companies may be slowed down for a certain period of time at the beginning of 2017.

IV OTHER NOTEWORTHY DEVELOPMENTS

i VAT reform regarding asset management products

The Chinese Ministry of Finance and SAT jointly issued Notice on Implementing the Pilot Program of Replacing Business Tax with Value-added Tax in an All-round Manner (Caishui [2016] No. 36) on 23 March 2016, which provides the detailed implementation guidance on the further rollout of the VAT reform pilot programme to sectors such as construction, real estate, financial services and lifestyle services, as well as modifications to the current value-added tax (VAT) rules for transportation services, modern services, postal and telecommunication services. The VAT reform in China takes a big step forward and attracts heated debate in the asset management industry recently. At the end of 2016 and the beginning of 2017, Circular on Value-added Tax Policies for Financial, Real Estate Development, Education Ancillary
 Service and Other Services and Supplementary Circular on Issues concerning Value-added Tax Policies for Asset Management Products were published, which require that managers of asset management products pay value-added tax in connection with their taxable activities during the operation of the asset management products as of 1 July 2017.

ii Expansion of negative list regime

Historically, all direct investment by foreign investors to a Chinese company (either greenfield investment or through merger and acquisition of existing Chinese companies) as well as foreign investors’ disposition of their direct equity interests in foreign-invested enterprises require the approval from MOFCOM or its local counterparts. On 3 September 2016, the Standing Committee of the PRC National People’s Congress passed a decision to revamp the PRC Law on Wholly Foreign Owned Enterprises, the PRC Law on Sino-Foreign Equity Joint Ventures, the PRC Law on Sino-Foreign Cooperative Joint Ventures, and the PRC Law on the Protection of Investments by Taiwanese, officially extending the ‘Negative List’ regime previously tested in the several free trade zones to the whole country effective as of 1 October 2016. The investments into domestic companies other than those engaged in an industry on the Negative List will not require prior approval by MOFCOM or its local counterparts and can be completed through submitting to MOFCOM or its local counterparts for recording and registering with the administration of industry and commerce. On 8 October 2016, the National Development and Reform Commission and the MOFCOM jointly published the Announcement No. 22 of Year 2016 (Announcement No. 22), in which they clarified that the scope of the Negative List shall be consistent with the Catalogue for the Guidance of Foreign Investment (2015 revision), jointly issued by MOFCOM and NDRC. On the same day, the MOFCOM promulgated the Interim Measures for the Record-filing Administration for the Incorporation and Change of Foreign-invested Enterprises (FDI Record-filing Measures). Announcement No. 22 and FDI Record-filing Measures became effective on the date of their respective promulgation. These ‘open-door’ rules will certainly be warmly welcomed by foreign PIFs and increase the competition in the PE/VC market in China.

V OUTLOOK

As a concept learned from the Western world, the PE and VC market in China has grown at a phenomenal rate over the past 20 years and helped create many of the leading companies in China. At the same time, this phenomenal rate of growth has also prompted myriad business and legal issues, some of which are unique to China. PRC laws and regulations have seriously lagged behind the development of the industry in many respects, and are also characteristically vague in many others, and the regulators are working hard to play catch-up while protecting their own turf. It is a most dynamic market in which the law changes much faster than in developed countries, and in which great opportunities and great challenges coexist.
Chapter 7

COLOMBIA

Hernando A Padilla and Federico Cárdenas

I GENERAL OVERVIEW

2014 was an excellent year for the Latin American private equity fundraising market, hitting a record of US$10.391 billion raised, surpassing the previous record of US$10.27 billion reached in 2011. Moreover, as of 2015, nearly US$7.2 billion was raised by private equity funds in Latin America. These statistics reveal that, despite the slowdown experienced by Latin American economies during the past three years, private equity sponsors and investors are confident in the future of Latin American economies, and hence are willing to invest in the region.

With respect to Colombia, private equity fundraising continued to grow during the past five years, thanks to regulatory efforts made by the government, and the interest of both international and local investors who have promoted the private equity industry and the country’s economic development. While in 2010 there were 30 private equity funds, of which only 11 had finalised the fundraising period and 19 were in fundraising stage, in 2016 more than 90 private equity funds were active, of which 67 had closed the fundraising stage and 20 were in the fundraising process. As of May 2016, closed private equity funds with operations in Colombia had received capital commitments for a total of US$21.93 billion for investments in Colombia and Latin America. Funds that are currently at the fundraising stage aim to raise US$3.331 billion for investments in Colombia and Latin America. In respect to Colombian private equity funds, the aforementioned statistics show a 690 per cent increase in closed private equity funds and a 5.2 per cent increase of funds in the fundraising process in respect to 2010.

1 Hernando A Padilla is a partner and Federico Cárdenas is an associate at Philippi Prietocarrizosa Ferrero DU & Uría.
6 Ibid., p. 33.
7 Ibid., pp. 23–7.
Of the private equity funds that are currently in the fundraising stage, 10 per cent are focused on multisector initiatives, 25 per cent on real estate activities, 20 per cent on agroindustry and 10 per cent on infrastructure.8

Colombian venture capital funds show increasing activity. Of the current nine venture capital funds, in 2016 five have closed the fundraising stage, raising US$93.2 million, and the four funds that remain in the fundraising stage aim to receive capital commitments of up to US$61.8 million.

Finally, impact funds seek the development and growth of enterprises not only from a financial perspective but also to have a positive social impact on the communities where the targets carry out their activities. In 2016, capital commitments of closed impact funds amounted to US$6.8 million, while impact funds in the fundraising stage intend to raise commitments for US$13.3 million.

![Figure 1: number of private equity funds and fundraising stage in 2016](https://via.placeholder.com/150)

<table>
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<tr>
<td><strong>Total</strong></td>
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The expansion of the private equity industry in Colombia is linked to the continuous growth of the economy since the early 2000s. Moreover, during the same period, the government has introduced regulations that have been welcomed by the private equity sector and supported initiatives aimed to promote the private equity industry. It is worth highlighting Bancoldex, an entity designated by the government to directly invest in private equity and entrepreneurial initiatives, and to provide training and networking in aspects related to the private equity industry as well as to promote it. As a result of the above, 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, private equity funds have diversified in terms of the type of investments pursued by them. Infrastructure is a sector that has raised attention and interest among investors and GPs. As a result of a solid public policy carried out by the government, the support

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8 Ernst & Young and Colcapital, footnote 5, p. 26.
9 According to LAVCA, Colombia currently ranks fourth, with the best regulatory landscape for private equity and venture capital investments in Latin America, behind only Chile, Brazil and Mexico: LAVCA, ’2015-2016 Scorecard. The Private Equity and Venture Capital Environment in Latin America’.
of national and international financial institutions and governmental initiatives aiming to channel private and public resources for infrastructure initiatives, infrastructure projects have become a common investment area for recently incorporated private equity funds. Among the principal investors in private equity funds in 2016, and being the largest investors, pension funds play an important role in the Colombian private equity market by providing 39.8 per cent of the capital commitments. Financial institutions lie in second place, with a 16.5 per cent participation, closely followed by funds of funds, which account for 7.9 per cent of the capital commitments. Multilaterals and governmental institutions are considered key players as well, especially in the past few years, by developing investment programmes focused on multiple sectors. Regarding the origin of the commitments, nearly 72.4 per cent of the investments come from local players, while the remaining 27.6 per cent are of international origin.10

Recent significant fundraisings include the following:11

a Fondo Energético Andino opened Compartment C, which successfully closed its fundraising process by raising US$40 million;
b SEAF Colombia Agrobusiness Fund ended its fundraising process in April 2015;
c Sura Asset Management and Credicorp created an infrastructure investment fund, which seeks to raise US$400 million to be invested in road infrastructure projects in Colombia. The principal (limited partners) LPs are pension funds and insurance companies. The fund will be managed by Sumatoria;
d Fondo de Deuda Senior para Infraestructura en Colombia CAF Ashmore I closed its fundraising, raising US$ 468,79 million;
e Caseif III LP closed its second fundraising process, including commitments made by the International Finance Corporation, a member of the World Bank Group;
f FCP BTG Pactual Deuda Senior Infraestructura 4G seeks to raise US$300 million to be invested in toll road infrastructure projects in Colombia; and
g FCP Aktiva Financiación Estructurada, a venture capital fund that successfully closed its fundraising process in December 2016 by raising US$32,8 million.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Legal form and jurisdiction

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

The regulation of private equity funds is mainly comprehended by Law 964 of 2005, Decree 2555 of 2010 (Decree 2555), which was amended in regards to collective investment funds and private equity funds by Decree 1242 of 2013, and the Legal Basic Circular issued by the Financial Superintendency. Accounting rules are governed by the Accounting and

10 Ernst & Young and Colcapital, footnote 5, pp. 30, 31.
Private equity funds may be administered by three types of entities – broker-dealer firms, investment company administrators and trust companies – all of which are under the supervision of the Financial Superintendency. These institutions may decide whether to appoint a general partner (GP) to manage the fund’s investments, and to carry out the investment and divesture policies or to carry out such activities by themselves. Market practice shows that fund administrators tend to appoint a GP to manage each fund.

The legal structure of private equity funds 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 said assets. Thus, upon a reorganisation or winding-up event of the administrator or of the GP, the assets of the fund will not enter into such procedures.

In regards to the jurisdiction of private equity funds that expect to operate and invest in Colombia, choosing an offshore location to incorporate the fund is not an uncommon practice.

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 dollars to be converted into Colombian pesos, and, when the participations are redeemed, Colombian pesos must be converted into dollars. Such transactions involve the registry of the foreign investment before the Colombian Central Bank and the filing of documentation before foreign exchange market intermediaries, encompassing additional paperwork and costs. The registry of investments made by international LPs grants investors the exercise of 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.

In regards to the jurisdiction of GPs, it is common for them to be incorporated as offshore entities. In fact, according to data collected in 2015, 48 per cent of the GPs were entities located abroad.

## Key terms

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

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12 Currently, Colombian entities are in the process of implementing the accounting rules of the International Financial Reporting Standards.

Administrator

As mentioned above, private equity funds must have an administrator. These entities are under the surveillance of the Financial Superintendency, and hence must comply with the obligations that regulations set forth for them in addition to the obligations applicable for administering private equity funds. The obligations of administrators mainly consist of:

- exercising the economic and political rights of the fund’s assets;
- complying with the applicable information duties of the private equity fund, especially with the reporting obligations before the Financial Superintendency;
- ensuring compliance with the applicable rules by the GP and the other actors involved in the private equity fund; and
- ensuring the compliance of the fund.

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

GPs

An external manager is usually appointed to carry out the management activity of private equity funds. The management activity mainly consists of performing the investment and divesture policy of the fund, as well as identifying, measuring, controlling and handling the risks of the fund. The private placement memorandum sets forth 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.

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 entails 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.

Investment committee

The members of the investment committee will be appointed by the GP. If there is no GP, it is appointed by the administrator. The investment committee is responsible for analysing investment alternatives and amounts, as well as the divesture and liquidation of investments. The private placement memorandum sets forth 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 as administrators for liability and fiduciary duty purposes.
Supervision committee

The supervision committee must oversee that the administrator and the GP perform their duties in accordance with the private placement memorandum and the applicable regulations. The members of the surveillance 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

Private equity funds 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, may establish different fees and investment strategies, and may be composed of only one investor. Each compartment will issue its own participation units.

The possibility of setting up compartments allows private equity funds 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 private equity fund are made through capital contributions. The private placement memorandum sets forth the minimum conditions and amounts for the capital commitments. To invest in a private equity fund in Colombia, the current minimum commitment must equal 600 monthly legal minimum wages, which in 2016 amounted to 413,672,400 Colombian pesos. Nonetheless, the private placement memorandum may set forth a higher amount for the minimum amount of capital commitments.

Usually, when the LPs adhere to the private placement memorandum, they subscribe a promise to pay the capital commitments within a period of time or once the capital commitment is made by the GP pursuant to the private placement memorandum. Decree 2555 allows the possibility of making in-kind contributions, provided that such 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 forth the terms and conditions that will govern all its 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);
functions and composition of the investment committee;
functions and composition of the surveillance committee;
mechanism for the distribution of profits;
administration and management fees;
rules and powers of the limited partnership meeting, and liquidation events; and
liquidation procedures.

Private placement memoranda are reviewed by the Financial Superintendency before the private equity fund commences its operations. Any amendment to the limited partnership agreement (LPA) must be submitted to the Financial Superintendency 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, private equity funds 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 private equity funds 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 setting the rules that will govern such co-investment.

**Key man provisions**
Due to the increase in the number of private equity funds and investment alternatives, some of these arespecialising in specific sectors. As a result, key man provisions have become critical to attract investors interested in investing in such sectors. Such provisions usually set forth 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-focus funds are a recent example that have appointed experienced individuals 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 the private equity funds. Participation units will be issued to the LP once the payment of the agreed capital commitments is made. Unless otherwise set forth in the LPA, capital commitments will not grant voting rights until the capital commitments are paid in full in accordance with the
terms of the private placement memorandum. Furthermore, participation units of private equity funds will be automatically listed in the RNVE and become publicly traded, provided that such decision is included in the private placement memorandum. The valuation of the funds’ participation units will be calculated on a daily basis.

The Colombian regulatory framework allows private equity funds to issue different types of participation units based on the LPs that invest in the fund. Each type of participation unit may set forth 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 Financial Superintendency have determined the key items that have to be disclosed.

In addition to the private placement memorandum, the prospectus of the fund shall also be disclosed. The prospectus is the document the administrators use to carry out the promotion of the fund, and it must contain at least general information about the fund, the investment policy and its risk profile, and the fund’s economic information, and identify the GP (if a GP is appointed). Moreover, said document must be written in Spanish, has to be consistent with the information set forth 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 Financial Superintendency. 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 forth 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 as 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 pertaining to the funds’ investments.

**Solicitation**

In connection with solicitation of investors, Colombian regulations do not establish specific limitations for the promotion of private equity funds located in Colombia, besides the obligation to provide truthful and clear information regarding the fund and the entities that are related to it (i.e., mainly the administrator and the GP). In fact, Decree 2555 and the Legal Basic Circular set forth the disclosure data that have to be available to the public.

Nevertheless, if an offshore private equity fund intends to promote and market its products and services in Colombian territory, it will have to open a representative office, enter into a foreign-finders agreement with a Colombian stock brokerage firm or set up a financial institution.
As a result of the reduced number of potential Colombian investors who invest in the asset class, GPs initiate the promotion of a private equity fund before the fund is set up. The reason behind this practice is to identify the requirements and profile that potential investors seek so that the GP and the administrator can include such conditions in the private placement memorandum and the prospectus. This practice is more evident in the case of pension fund administrators, which, due to their importance as potential investors and their strict investment criteria, need to verify that the private equity fund will comply with all the requirements applicable to them and 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 such requirements as long as they are in line with their own objectives.

In regards 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 as administrators pursuant to the definition of ‘administrator’ under Law 222 of 1995. Decree 2555 sets forth 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. Due to the fiduciary nature existing between the fund’s administrators and the GP towards the LPs, administrators, GPs and members of the investment committee shall observe principles and obligations such as a duty of care towards the investors, acting in good faith 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.

III REGULATORY DEVELOPMENTS

Due to the structure of private equity funds, the entity that serves as a fund administrator is supervised by the Financial Superintendency. Hence, the administrator will have to comply with both the specific obligations applicable to private equity funds and with the obligations related to their condition as surveilled financial entities.

Private equity funds must be registered before the Financial Superintendency. Even though Decree 2555 sets forth that private equity funds do not require prior authorisation for registration, a procedure must be undertaken by the administrator to obtain registration before the Financial Superintendency. The administrator files the private placement memorandum and other ancillary documents with the Financial Superintendency, which may provide observations and modifications to be included in the private placement memorandum. Once the observations made by the Financial Superintendency are satisfied, said entity will issue a communication stating that it has no further objections or comments. At this point, the fund may start its operations. According to recent experience, it takes an average of three months from the submission of the fund's documentation to the Financial Superintendency to start

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14 Law 222 of 1995 sets forth the obligations and duties that officers and directors (considered as administrators as per the scope of Law 222) must comply with.
15 Insurance companies have recently introduced insurance policies for GPs.
the fund’s operation. GPs do not have to register to undertake their managing activities in Colombia. Nevertheless, pursuant to Decree 2555, GPs must comply with specific disclosure obligations resulting from the performance of their management activities.

For tax purposes, private equity funds are considered pass-through entities, as they are subject to the tax-transparency principle, which entails that any income received by the private equity fund 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 private equity fund 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 as resident for tax purposes or the source of income).

To date, the vast majority of the divestiture of portfolio companies by private equity funds have 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 40 per cent.

Among recent modifications to the applicable regulations, the following are worth mentioning:

Decree 816 of 2014, issued by the Ministry of Finance and Public Credit, modified the applicable investment regimes for institutional investors to promote and bolster investments in infrastructure projects. The Decree expressly authorises private equity funds to invest in debt issued by concessionaires, and to supply credits and acquire a concessionaire’s portfolio.

Decree 1403 of 2015, issued by the Ministry of Finance and Public Credit, allows private equity funds to invest 100 per cent of their investment commitments in real estate assets without the need to change their legal nature into a real estate fund.

In December, 2014, the Financial Superintendency issued Circular Letter 034 of 2014, under which the valuation of assets of private equity funds is regulated. The Circular sets forth that such activity must be performed by an external consultant. However, GPs and administrators argue that the rules for the valuation are not clear enough, that the expertise of the valuaturs is uncertain, that it will entail further costs to the fund and that there are concerns regarding the confidentiality of a fund’s information. In response to the Circular, associations of private equity funds and of administrator entities have proposed alternatives so that the assets valuation is made by the statutory auditors of the fund or by the GPs in accordance with certain guidelines.

Under Decree 765 of 2016, the Ministry of Finance and Public Credit modifies the pension fund investment regime to:

a reorganise admissible assets in accordance with a risk-based approach, allowing segregation of traditional assets and alternative assets;

b introduce a new category of assets – ‘restricted assets’ – aimed at contributing towards the diversification of risks associated with pension funds; and

c modify investment caps and requirements for currently admissible assets, especially for investment vehicles incorporated by foreign issuers.

16 LAVCA 'Policy Meeting Colombia’, 2015.
17 Ibid.
18 The category of restricted assets includes hedge funds and investment vehicles in which more than 10 per cent of the underlying assets are high-yield securities.
Wealth tax was introduced in 2015 by Law 1739. It is applicable to entities and individuals that own assets, or that have a net worth of or exceeding, 1 billion Colombian pesos after the deduction of debt.

Finally, Law 1819 of 2016 introduced a structural tax reform that includes:

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

**IV OUTLOOK**

Due to a strong devaluation of the Colombian peso against the US dollar, it is expected that during 2017, many international equity firms will look to Colombia to deploy capital in investment opportunities in order to profit from the current exchange rate and continuous economic growth.

We expect that the number of buyout funds will stabilise, while industry-specific funds will continue to rise.

Finally, taking into account the fact that a large segment of funds will begin their exit periods very soon, during the next years we will see an increase in divestures and exits. We anticipate that certain funds will seek to exit their investments through initial public offerings. These exits may lead to an additional wave of fundraising aiming to attract the revenue product of funds’ profit distributions.
Chapter 8

GERMANY

Felix von der Planitz, Natalie Bär, Guido Schlikker and Tim Kreutzmann

I GENERAL OVERVIEW

Compared to the previous year, in 2016, private equity fundraising has more than doubled to €2.33 billion, as reported by the German Venture Capital Association (GVCA) in its annual yearbook. This was primarily due to a significant increase in the fundraising of buyout funds to €1.27 billion. On the other hand, venture capital fundraising with €0.55 billion is around a quarter lower than its value by the end of the last year. Investments into German-based portfolio companies decreased to €4.17 billion; this is about 30 per cent less than in the previous year. Seventy-six per cent of investments were made into buyouts.

The German tax and regulatory environment has become even more challenging for private equity funds (i.e., BEPS, FATCA/CRS, 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, 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 has 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 UK, 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.

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.

1 Felix von der Planitz is a partner, Natalie Bär and Guido Schlikker are senior managers, and Tim Kreutzmann is a senior consultant at PwC.
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 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.

In this section, no distinction is made between AIF that are internally managed and AIF that are externally managed. An internally managed fund, namely a fund that does not appoint an external manager but rather manages itself and obtains authorisation as an AIFM, is, however, in practice generally the exception regarding German AIF.

i German limited partnership (KG)

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

The general partner can be a German limited company (GmbH) or even another German limited partnership (e.g., a GmbH & Co KG). Given the illiquid nature of private equity-related investments, it is in principle not possible to set up a private equity fund as open-ended. Shares in a closed-ended investment KG may according to the KAGB only be held by (semi-)professional investors directly. A trustee arrangement may only be used in the case of a closed-ended retail investment KG, whereby the agreement must limit the activity of the fund to the investment of raised capital and management of the held assets (no operative or commercial activities). The fund must have a defined investment policy additionally to the limited partnership agreement. The limited partnership agreement can be written in English, but a German translation of all documents is necessary for retail investors. 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, the German Federal Financial Supervisory Authority (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 need 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. Under German partnership law, such responsibilities should not cause the limited partner to lose its limited liability. 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. Currently, there are discussions with BaFin as to the scope of the responsibilities allowed to remain with the managing limited partner if the fund is managed by an external AIFM; 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 (KGaA)**

Another local fund structure is the KGaA that 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 (KAGB)**

We highlight specific German regulatory rules of the KAGB in this section.
Scope of AIFMD/KAGB regulation
In general, all EU-managers of AIF are subject to the European AIFMD regulation. As mentioned above, the KAGB implements 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 the German supervisory authority (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.

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.)

**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 private equity fund for retail investors has to be structured either as a closed-ended limited partnership or as an investment stock corporation with fixed capital. The latter vehicle will most likely seldom be used due to 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 always be invested according to the principle of risk diversification, may only borrow up to a certain percentage calculated with respect to the fund’s aggregated capital paid in by the investors and the undrawn capital commitments, may not have a net currency exposure of more than 30 per cent of its net asset value and may not employ any short selling.3

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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3 Note that only funds qualifying as hedge funds under the German definition of the KAGB may employ short selling.
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.

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 needs 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 business plan including information on the AIF and the specified domicile of the AIF;
- contractual terms and legal documents of the AIF;
- name of the depositary; and
- 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 respective 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 period of time.
Client classification
Given the fact that funds for professional and semi-professional investors are regulated less restrictively due to the lower level of consumer protection required compared to 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 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 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 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 he or she fulfils the requirements that justify the lower level of protection. This is assumed to be justified if he or she makes a minimum investment of at least €10 million. Beyond this, the process for assessing whether the investor is qualified has not been thoroughly discussed with BaFin and raises many questions. Depending on who distributes, either the AIFM or its distribution partner are 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 the investor has sufficient financial resources to back his or her allocated risk appetite.

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

The AIFM needs 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 he or she has the relevant qualification, he or she is deemed to be able to judge the suitability of the investment for him or herself. This, however, is based on the assumption that the investor is not as well versed in market knowledge and experience as the professional investor definition stated under the MiFID.

If the AIFM believes that the investor is able to make investment decisions by him or herself and thus understands the inherent risks, and that such commitment is appropriate for the investor concerned, then the AIFM 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 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 (UBGG)

German private equity funds may consider registering under the 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 such law. 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. Such 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 applied directly in all Member States to venture capital funds that are neither UCITS, nor exceed the thresholds of the AIFMD and that are 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. 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

As of 2016 the Ordinance governing the Restricted Assets of German pension schemes and pension funds has been amended. The amendment concerns in particular new rules for investments in alternative assets, such as private equity or private debt funds.

IV TAX DEVELOPMENTS

On 5 October 2015, the OECD published final reports in relation to all 15 BEPS\(^5\) actions setting out a package of a comprehensive and coordinated reform of the international tax

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\(^5\) BEPS: base erosion and profit shifting. The OECD’s Action Plan was published in July 2013, and identifies 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions.
rules. The key BEPS actions relevant for the private equity funds are related to neutralising the effects of hybrid mismatch arrangements (action 2), interest deductibility (action 4), preventing the granting of treaty benefits in inappropriate circumstances (action 6), and permanent establishment status (action 7). Significant changes in these areas have been proposed by the OECD.

As part of the follow-up work on BEPS action 6, on 24 March 2016, the OECD published a consultation document on the interaction between the treaty provisions of the final report and the treaty entitlement of non-collective investment vehicles (CIV) funds, alternative investment funds such as private equity and hedge funds. The paper included a number of specific questions, as to how the new provisions could affect the treaty entitlement of non-CIV funds as well as possible ways to address these concerns. These non-CIVs could in some way be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits, and that investors could use non-CIVs as a way to defer recognition of income.

Addressing BEPS has become a high priority for governments around the world, also for Germany’s coalition government. It may take a while for the impact of these recommendations to be fully applied in tax practice, however, the first draft tax bill (the BEPS 1-Implementation Act) to implement part of the BEPS plan into the German domestic law has been approved by the German Bundestag and Bundesrat in December 2016. The focus of the draft bill is mainly on the measures to counter harmful tax practices as well as transfer pricing documentation and country by country (CbC) reporting. Additional BEPS measures, for example, regarding action 2 and CFC taxation, are expected to be included in subsequent bill. It is proposed that the law would apply for assessment periods from 2017 onwards. The main legislative changes relevant for private equity funds include:

a. the implementation of the OECD’s transfer pricing recommendations (master file and local file concept, CbC reporting);
b. the interpretation of the arm's length principle in German tax treaties solely in accordance with the German Foreign Tax Act;
c. inclusion of controlled foreign corporation (CFC) income for trade tax purposes: any CFC income will be deemed to be derived within Germany despite its actual source, thus, might be subject to trade tax as well;
d. narrowing the scope of finance and holding companies that are not eligible for the participation exemption on dividends and capital gains realised on corporate shares;
e. prevention of a double deduction of business expenses for partnerships or treatment of special business expenses: the new rule targets the situations where, for example, the refinancing expenses are deductible as special expenses both at the level of the partnership as ‘special expenses’ and abroad at the level of the partner; and
f. introduction of additional measures to prevent certain abuse tax structuring schemes in the future.

The issues below, which are relevant for fund taxation, have already been discussed in previous years but remain on the agenda for 2017 or even later:

a. in keeping with similar practice for dividend taxation, it has been suggested to abolish the 95 per cent exemption on the sale of portfolio shareholdings (less than 10 per cent); and
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 the carried interest from taxation (see below).

Another reform efforts that is worth mentioning, is the promotion of venture capital in Germany in order to be internationally competitive as a location for venture capital investment. During the current legislative period the government has launched measures to improve conditions for venture capital, as envisaged in the coalition agreement, however, a new legislation was not adopted. The government plan, inter alia, to work on legal clarity on whether venture capital funds engage in trading or asset management activities as stipulated in the tax guidance letter dated 2003, should case law on the requirements for asset management activities become stricter. How the reform will develop remains to be seen.

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

i German Investment Tax Act (ITA)

The current fund tax rules came into effect on 24 December 2013. Once again, the government has now changed the regulations. The current tax regime is still applicable until 31 December 2017. For details of the new ITA please refer to Section IV.vii, infra.

Under the current law private equity funds usually fall under the scope of the ITA irrespective of their legal form. The most favourable tax regime (taxation as a fully transparent ‘investment fund’) does not apply to typical private equity funds as they do not meet the criteria required for such qualification. In particular, the limitations for investments in non-listed companies or corporations should prevent private equity vehicles from being taxed as an ‘investment fund’. Generally, funds not meeting the test of an ‘investment fund’ are classified as ‘investment companies’. The ITA draws a distinction between investment companies in the legal form of partnerships on the one hand (partnership investment companies) and corporate entities on the other (corporate investment companies), which are subject to different tax regimes. Private equity funds will usually qualify as partnership or corporate investment companies, depending on their legal form.

For 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.

ii 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, 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 in order to be qualified as an asset management partnership. Such restrictions used to be significantly stricter than those under the tax concepts of, for example, the US or the UK. However, German funds have developed a high level of discipline to deal with the criteria, and have often received 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 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 it qualified as a trading partnership, such 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). Such discussions 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

According to the current ITA, private equity funds in the legal form of a corporation are usually qualified as ‘corporate investment companies’ due to the fact that they do not meet the investment fund test. 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 with 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.

Corporate investment companies are generally taxed as corporations according to the German income tax rules subject to certain modifications. The ITA explicitly envisages the applicability of the German Controlled Foreign Corporation Rules (the CFC Rules) and Passive Foreign Investment Corporation Rules (the PFIC Rules) for foreign low-taxed corporate investment companies. The German legislator chose the application of the CFC and PFIC Rules over the primarily intended lump-sum tax regime, which caused a great deal of controversy. In the event that the CFC or PFIC Rules apply, 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.

As far as the CFC or PFIC Rules do not apply, dividends received from corporate investment companies and realised capital gains from the sale of shares in such companies can be fully taxable for all types of investors. Potential tax exemptions on the level of corporate or business investors (participation privileges) are only available if the corporate investment company is subject to specific taxation in its country of residence (15 per cent for companies located outside the EU or EEA, or some effective income taxation for funds within the EU or EEA). Consequently, dividends and capital gains from foreign corporate private equity funds, which will typically not be subject to tax in their country of residence, should be taxed at the investor level without participation privileges being available (subject to double tax treaty provisions). This denial of participation privileges is a huge downside compared with funds established in the legal form of partnerships. Only tax-exempt investors, as well as life and health insurance funds, which were not previously entitled to claim tax exemptions, are not negatively affected by the new rules.

An objective reason for the detrimental tax treatment is not evident. 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.

Finally, it should be noted that the German legislator has already passed an ITA reform act that will take effect on 1 January 2018 and provides fundamental changes to investment taxation (for details please see Section IV.vii, infra).

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). Such PPS was expressively 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 such 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.

Due to the fact that 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 which extent these costs are to be allocated to acquired assets and capitalised as incidental acquisition costs and to which extent they have to be (re)qualified 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 annually capitalised during the total investment period in the proportion of the outstanding commitment at the end of a respective year to the total fund’s 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

In 2004, Germany introduced specific carried-interest legislation to promote private equity funds and investments in German portfolio companies.

Under such 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, such 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;
- **b** full payout – the carried interest will be granted subject to a full payout of capital contributed by the investors. Such 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 such guidance letter is not lawful, since the dividends are entitled to the general 40 per cent participation exemption unless anti-abuse legislation would apply that provides for additional conditions.

vii German ITA reform act

On 8 July 2016, the German ITA reform act passed the German Bundesrat. The final amendments made during the parliamentary process do not constitute substantial changes to the ministerial draft published on 16 December 2015 by the German Federal Ministry of Finance. The ITA reform act will take effect on 1 January 2018 and sets 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 do not qualify as a special fund).

In contrast to current legislation, the new ITA provides for an expansion of the scope of application to cover all UCITS and AIF. Under the new opaque tax regime investment funds (mutual and retail funds) will be 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. The 95 per cent exemption for investment income will not apply at fund level. Moreover, German funds can be subject to trade tax, depending of their structure and commercial activity.

At the level of an investor the income will be taxed upon distribution and transfer or redemption of fund units. In addition, investors will be 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 will be subject to flat tax regime (25 per cent plus surcharges). For investors that hold their investment as a business asset, the income will be 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 will not apply. With respect to investment proceeds from mixed funds, real estate funds and equity funds certain partial exemptions are applicable.

The taxation of special funds and their investors will be similar to the taxation of the mutual funds, provided they do not opt for a transparent regime.

The tax situation for private equity funds and their investors will not improve with the amendment of the German tax law. Private equity funds in the legal form of partnerships – that are not UCITS – are not in the scope of new ITA. General rules on the taxation of partnerships will continue to apply (refer to Section IV.ii, supra). By contrast, private equity funds in the legal form of a corporation will usually be in the scope of the revised ITA and taxed under an opaque regime.

V OUTLOOK

Future fundraising for private equity funds in Germany will be dominated by the implementation of 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 FCPPRs, 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. Lastly, the revision of the ordinance for the investment of restricted assets of German insurance companies may have an effect on how funds need to 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.
I GENERAL OVERVIEW

A mere 30 years ago India was an insular economy cut off from global markets and trends, but it has evolved in leaps and bounds and in 2017 is now one of the strongest emerging market economies. Its journey has not been without obstacles, given the global financial crisis and other macro and micro economic factors, but a marked economic recalibration has occurred with a focus on manufacturing and industrials, and a renewed interest in IT and services.

PE in India is still a nascent story, starting to spread its roots deep within the Indian economy and showing promising new developments. It has evolved from ‘vanilla’ equity into multiple and multifarious asset classes, structured investments and play across sectors. In fact, today, India’s largest owner and developer of commercial real estate is a private equity fund.

2016 v. 2015

According to a market survey conducted by the Emerging Markets Private Equity Association, India was ranked as the second most attractive market for GP investments in 2016 (a substantial rise, being only ninth in 2013 falling behind Latin America, South East Asia, Brazil and other developing markets). Further, LPs ranked India as the fourth most attractive market globally. Pension funds ranked India as the second most attractive market while funds of funds and private market advisors ranked India as the most attractive market.

2016 had a momentous start, abuzz with a healthy amount of fundraising activity. A historic US$2.1 billion worth of funds was raised in the first quarter of 2016 itself, which was a significant 56.6 per cent increase from the last quarter of 2015. However, the subsequent quarters of 2016 witnessed a significant slowdown in fundraising activity. The second quarter of 2016 reported a 55 per cent decline from the first quarter, at US$942 million. While US$3.3 billion through 29 funds was raised in the first half of the year, only 14 funds adding...
up to US$895 million was raised in the last two quarters. Consequently, fundraising dipped by 26 per cent in 2016: US$4.2 billion was raised, in contrast to the US$5.7 billion raised in 2015.\(^6\)

Despite this interest expressed by the LPs in the Indian market for the past year or so, scepticism was expressed through the significant slowdown that occurred in fundraising. It is possible that LPs are yet to see the whole cycle of investments in India and are still struggling to address the patchy track record and plethora of GPs (both international and home-grown).\(^7\)

Further, investments made during the peak years of 2006–2007 have been a learning curve for the LPs, as most of those investments have not exited yet due to high entry valuations. Currency and political risk, foreign exchange volatility, weak exit environments, and challenging tax and regulatory issues have been some of the deterring factors for investment in India by LPs and much talked about by market commentators.\(^8\) In addition to these deterring factors, the US elections, uncertainty regarding the impact of demonetisation and delay in revival of the domestic economy have caused the foreign investors to take a cautious approach towards India in 2016. Despite this, India does remain a desired investment destination due to strong emerging market fundamentals such as a growing middle class, domestic market volume, relatively cheap labour, a democratic government and somewhat buoyant capital market.

The trends in 2016, not surprisingly, indicate LPs’ preference for experienced fund managers. For instance, the top five funds constituted 85 per cent of the funds raised in the first quarter of 2016,\(^9\) while 12 out of 14 funds raised in the third quarter of 2016 were follow-on funds.\(^10\)

2016 also witnessed an upcoming trend of co-investment platform creation and direct investments owing to LPs’ need for greater control over their underlying assets and their ability to take a longer-term view especially for pension and sovereign wealth funds, in sectors such as infrastructure and real estate.\(^11\) Brookfield Asset Management Inc (Brookfield) committed US$1.03 billion into a joint venture with the State Bank of India, which will invest in distressed assets.\(^12\) Kotak Mahindra Group and the Canadian Pension Plan Investment Board (CPPIB) came together to invest US$525 million in stressed assets in the banking and corporate sectors of India. Of this US$525 million corpus, CPPIB will be investing US$450 million.\(^13\) Further, Tata Power Co Ltd and ICICI Venture Funds Management have created a platform, Resurgent Power Ventures Pte Ltd, to invest in power projects. Resurgent


\(^11\) [www.privateequityinternational.com/uploadedFiles/Private_Equity_International/PEI/Pagebuilder/Aliased/Campaigns/Supplement_Hub/PEI%2020145_IndiaSupplement_digital.pdf](http://www.privateequityinternational.com/uploadedFiles/Private_Equity_International/PEI/Pagebuilder/Aliased/Campaigns/Supplement_Hub/PEI%2020145_IndiaSupplement_digital.pdf)


Power Ventures Pte Ltd raised an initial capital of US$850 million from Caisse de dépôt et placement du Québec (CPDQ), Kuwait Investment Authority and State General Reserve Fund of Oman.14

ii Industry sector trends

Many sectors remain in focus including industrials, manufacturing, real estate, education enabled by technology, financial services, IT and services, consumer products and healthcare players. While IT and services saw some major action during 2016, the healthcare sector has witnessed abundant activity but far less closed fundraising. The market saw a long-awaited slowdown in e-commerce investment. Real estate and infrastructure were the focus of most of the funds raised, while investors also showed increased interest in distressed assets.15 The early-stage fund of US$920 million raised by Sequoia was the largest India-focused fund raised in 2016.16

iii Real estate

HDFC raised US$405 million in the first close of its new fund HDFC Capital Affordable Real Estate Fund – 1 to invest in mid-income housing projects across India. Other significant real estate-focused fundraising included Kotak Realty Fund III (US$250 million), Motilal Oswal Real Estate Fund III (US$75 million) and Indiabulls Realty Fund (US$75 million). IDFC Score Fund is aiming to raise around US$110 million to invest in residential projects in key markets.17

iv Financial services and consumption sector

Gaja Capital, which focuses on the consumption sector, closed its third fund at US$240 million with a view to invest in ventures of first generation entrepreneurs.18 The Small Industries Development Bank of India announced a Stand Up India Fund of US$1.5 billion, which will focus on Dalit and women entrepreneurs.19 Oman India Joint Investment Fund reached the first close of its second fund at US$250 million, with major contribution of US$200 million coming from State General Reserve Fund of Oman and State Bank of India. The focus of the fund will be financial services, consumers and industrials.20 Plenty Private Equity Fund I has announced plans to raise up to US$600 million, of which it plans to allocate US$150 million towards investment in India’s financial technology sector. The CPPIB has committed US$140 million to this fund.

15 www.privateequityinternational.com/uploadedFiles/Private_Equity_International/PEI/Pagebuilder/Aliased/Campaigns/Supplement_Hub/PEI%20145_IndiaSupplement_digital.pdf.
v Sector agnostic funds
Multiples Alternate Asset Management closed its second fund at approximately US$690 million, which is the fifth largest sector agnostic corpus raised for India. This fund received most of the contribution from international investor and around 10 per cent of the fund was raised from domestic investors.21 International Finance Corporation, a World Bank organisation for private investment, has also contributed to this fund.22 Tara Fund IV of US$60 million raised by IL&FS Investment Managers Ltd23 and the US$190 million India Advantage Fund raised by ICICI Venture Funds Management24 are some of the other significant sector-agnostic funds raised in 2016.

vi Distressed assets
In contrast with previous years, investors have shifted their focus to the area of distressed asset management in 2016. This could be attributed to the Reserve Bank of India’s plan to clean up the balance sheets of the public sector banks, the new bankruptcy code and relaxation of FDI to 100 per cent in asset reconstruction companies. Significant fundraising in this sector included the US$900 million Piramal India Resurgent Fund, US$750 million fund planned to be raised by Edelweiss Financial Services Ltd and the US$190 million joint platform of Kotak Mahindra Group and the CPPIB.25

vii Investments and exits
2016 has seen a decline in PE investments and exits in comparison to the strong and robust 2015. Slowdown in investment activity has been attributed to the dampening of the foreign investors’ sentiments due to economic and political turmoil in Europe, including Brexit, the US election and the volatile oil prices.26 As a result of such a sluggish investment environment in India, the initial drastic surge in fundraise led to piling up of dry investment powder in India, amounting to approximately US$5.6 billion.27 Having said that, Canadian investors contributed significantly to the investment activity in India, with Brookfield announcing investments worth US$2.6 billion and CDPQ setting up its office in India and signing a partnership agreement with Edelweiss Financial Services Ltd.28 There was a sharp decline of 90 per cent in e-commerce investments in the third quarter. Interestingly, the total value of buyout deals increased in 2016, indicating a shift in trend towards investors’ preference for effective value creation and independent decision making at the time of exits. The most notable investments in 2016 were the acquisition of a 51 per cent stake in Towercom Infrastructure Pvt Ltd by Brookfield for US$1.61 billion from Reliance Communications Ltd29 and the acquisition of controlling stake by Blackstone Partners in Mphasis Limited from Hewlett

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22 IFC had committed US$40.6 million to this fund in April 2016.
Packard for US$825 million. Other significant buyout deals include the secondary purchase of shares of Eicher Motors by Cartica Capital for US$308 million, sale of a 33 per cent stake in Bangalore International Airport Limited by GVK Power & Infrastructure Ltd to the Fairfax group for US$321 million and the acquisition of the financial services business of GE Capital Services India by AION India along with Anil Chawla and Pramod Bhasin (former GE executives).

On the exits landscape, KKR’s exit from Alliance Tire for US$1.2 billion is believed to be the largest PE exit in India announced in the past decade. PE-backed IPOs gained momentum in 2016 with as many as 12 conducted until September 2016, which is the highest in the past five years. KKR’s exit from Gland Pharma for US$542 million was one of the other large exits of 2016.

viii Reception by LPs and fund managers
Owing to LPs’ scepticism of the Indian market on account of the disappointing past performance of their investments and the uncertainty looming over the legal regime, the fund manager has to work harder to convince the LPs and a proven consistent track record has become of primary importance. As a case in point, GPs have currently been in the market for close to two years and are yet to achieve first close, while any change or deviation from the past investment practices is often rejected upfront by potential LPs. To cut a long story short, fundraising easily ends up in excess of a year and continues to be a struggle for fund managers (especially for first-time managers) in India.

II LEGAL FRAMEWORK FOR FUNDRAISING
i Structure of offshore funds
Typically the offshore fund is set up either in the form of a limited liability partnership or a corporate entity in a tax-efficient jurisdiction outside India. The GP, along with the investment manager who set up and operates the investment vehicle, are located outside India. They seek to raise capital from LPs, who play a very passive role in operating the fund. The GP and the investment manager engage an advisor based in India (often an affiliate of the offshore fund), who scouts for investment opportunities for the fund. A co-investment structure is opted for when the commercial understanding is to raise two distinct pools of capital for offshore and onshore investors.

ii Preferred jurisdictions for offshore funds
Background
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, such taxation implications are nullified and the Indian income tax laws apply only to the extent they are more beneficial as compared to such tax treaties.

Understandably, 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 double taxation avoidance agreements with various countries such as Ireland, Mauritius, the Netherlands and Singapore. Rumour has it that the India is considering adopting a common tax agreement across various countries to ensure uniform tax regulations, regardless of the domicile of investors.33

Below is a brief overview of the various jurisdictions where India-focused funds are set up.

**Mauritius**

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, which provides various benefits like tax exemption on capital gains, robust dispute resolution network, and the right to repatriate capital and returns. However, the Indo-Mauritius DTA was amended in 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 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 phase out of the capital gains exemption is only applicable to sale of shares and not in respect of the sale of debentures.

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. 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 time to investors to reassess their investment structures in relation to India.

**Singapore**

The benefit under the India-Singapore DTA is available only to entities that reside or are domiciled in Singapore. Further, the treaty benefits are linked to satisfaction of certain conditionalities, which is 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 the capital gains exemption. In addition, the entity should not be a shell or conduit company.

The capital gains exemption under India-Singapore DTA was co-terminus 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

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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.

The Netherlands
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 shares of an Indian company. In addition, for a Dutch entity to avail itself of relief under the India–Netherlands treaty, it needs to be liable to pay tax in the Netherlands. Hence, the treaty works well for investors based out of the Netherlands to achieve tax gains out of India.

With recent changes made to the treaties with Mauritius and Singapore, there were discussions around amending the treaty with the Netherlands as well. For now, both India and Netherlands have maintained the status quo regarding the India–Netherlands DTA.

Cyprus
In 2013, India blacklisted Cyprus as a non-cooperative jurisdiction, for not providing financial information sought by the Indian government to curb money laundering. This stand was reversed in November 2016, when India and Cyprus inked a new DTA to bring the provisions up to par with the India–Mauritius DTA. The DTA also provides for assistance between the two countries for exchange of information between the two nations, which will be used for purposes other than taxation.

iii Investment routes for offshore funds
Most private equity players infuse funds into an Indian company either by directly investing in the Indian portfolio company or by investing in a pooled fund (onshore or offshore), which in turn invests in the Indian portfolio company.

Based on the investment strategy and sectoral focus, an offshore fund can directly invest into an Indian portfolio company through the following routes.

FDI route
This route is typically used by investors who wish to have a direct business interest in the Indian portfolio company, either by way of subscription or secondary purchase of securities, subject to compliance with the pricing guidelines, sectoral caps and certain industry specific conditionality as set out under the consolidated foreign direct investment policy dated 7 June 2016, issued by the Department of Industrial Policy and Promotion (the FDI Policy) and Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2000 (FEMA 20). Any investment in excess of the sectoral caps or not in compliance with the sectoral conditionality requires prior approval of the Foreign Investment Promotion Board (FIPB).

FPI route
Foreign investors who wish to trade in Indian listed stocks on the floor of the stock exchange may opt for this route after obtaining prior registration as a ‘foreign portfolio investor’ (FPI) from designated depository participants under the SEBI (Foreign Portfolio Investors) Regulations 2014 (the FPI Regulations). In order to rationalise different routes for foreign
portfolio investments and create a unified and simplified regulatory framework for foreign institutional investors, qualified institutional investors and sub-accounts, the security watchdog, Securities and Exchange Board of India (SEBI), introduced the FPI Regulations. The regulations limit the individual holding of an FPI below 10 per cent of the capital of the company and the aggregate limit for FPI investment to 24 per cent of the capital of the company. However, 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 intimation to the Reserve Bank of India (RBI). FPIs need to be registered with a designated depository participant before dealing with securities as a foreign portfolio investor. The process is fairly simple, and ordinarily it does not take more than 30 days to obtain the certificate.

**FVCI route**

The FVCI route is generally used for venture capital investment into unlisted Indian companies, although investment by such entities into listed Indian companies is also permitted subject to certain limits or conditions. Investment under 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 under 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 under the FVCI Regulations. The process typically takes 20–30 days from the date of application.

**iv Structure of domestic funds**

**Alternate investment funds**

In 2012, SEBI introduced the SEBI (Alternative Investment Funds) Regulations 2012 (AIF Regulations) to regulate privately pooled investment vehicles that collect funds from investors. 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.

Based on the nature of the funds and their investment focus, the AIF Regulations categorise funds into Category I AIF,\(^34\) Category II AIF\(^35\) and Category III AIF.\(^36\) Such categories of funds also have distinct investment conditions and restrictions to comply with during their life.

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\(^34\) An AIF that invests in start-up or early stage ventures or social ventures or small and medium enterprises or infrastructure or other sectors or areas that the government or regulators consider as socially or economically desirable (including venture capital funds, SME funds, social venture funds, infrastructure funds, angel funds and other AIFs as may be specified).

\(^35\) 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.

\(^36\) 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 make short-term returns or such other funds that are open ended can be included.
India

The AIF Regulations prescribe, *inter alia*, a cap on the number of investors pooling into the AIF to 1,000, conditionality on the minimum corpus for the fund and a minimum amount to be invested by an investor. In order 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 through the life of such AIF. Further, investment by the sponsor or manager of a Category I AIF and Category II AIF needs to be at least 2.5 per cent of the corpus (at any given point) of the AIF or 50 million rupees, whichever is lower.

Before commencing operations, AIFs should obtain a registration from SEBI, which takes about four to six weeks.

**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 sector and infrastructure sector respectively.

Both the regulations are along the same lines, including conditionality in relation to the 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 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.

**Foreign investment in domestic funds**

Until 2015, these investment vehicles were heavily funded by domestic investors since prior permission of the FIPB was required if the overseas funds intended to directly invest in a privately pooled vehicle in India. In order to increase the participation of offshore funds in these investment vehicles, in November 2015, the RBI permitted such investment vehicles to receive investments from non-resident Indian investors, FPIs and foreign investors under the automatic route, as long as ‘control’ of such investment vehicles vested in the hands of ‘sponsors’ and ‘managers or investment managers’, that are Indian ‘owned and controlled’ under the foreign extant regulations. With the announcement, the total amount of funds raised and investments made by AIFs increased exponentially.37

**III SOLICITATION, DISCLOSURE REQUIREMENTS AND FIDUCIARY DUTIES**

Typically, the investment vehicles issue a private placement memorandum (PPM) or an offer document in order 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, risk management tools. in Category III AIFs.

With respect to offshore India-focused funds, the disclosure requirements, marketing guidelines, limits on solicitation are governed by the laws of the fund’s domicile or

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37 An increase in the total amount of funds raised from 43.76 billion rupees in December 2015 to 48.55 billion rupees in June 2016. Available at www.sebi.gov.in/cms/sebi_data/attachdocs/1477629704398.html.
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 of valuation reports and filing of PPM with the SEBI, for the domestic funds. Further, there are limitations on the number of investors that an investment vehicle can attract. For instance, no scheme of an AIF (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 cast 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 are strictly 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 its investors and disclose any potential conflicts of interest.

IV TAXATION

i Taxation of foreign funds

Typically, India-focused offshores funds are organised in tax-friendly jurisdictions. However, with the adoption of the General Anti-Avoidance Rules (GAAR) from 1 April 2017, the Indian tax authorities will have the ability to treat arrangements outside India as an ‘impermissible avoidance arrangement’ if the main purpose of such arrangement is to obtain a tax benefit and such 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 adhere to the substance requirement to enable it to be eligible for tax treaty benefits.

Further, there is a potential risk of taxation of offshore funds in India on account of two factors:

a association of persons: tax laws in India recognise the concept of an association of persons as a separate taxable entity. This means that if a foreign fund along with a domestic fund come together with a common purpose to earn income, it may be viewed as a potential association of persons, which is a separate taxable entity under Indian taxation laws; and

b permanent establishment in India: in addition, there is a risk of an offshore fund being perceived to have a ‘permanent establishment’ in India on account of its relationship with the investment advisory team based out of India, in which case it will be liable to tax in India. In order to determine the actual residency status of an entity, the concept of ‘place of effective management’ (POEM) was introduced in 2015 and the regulatory framework in put in place in early 2017 (the POEM Guidelines). Under the POEM Guidelines, the key guiding principle to determine POEM is whether or not the entity is engaged in ‘active business outside 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 unit holders. The taxation of Category III AIFs depends on the
legal status of the fund (i.e., company, limited liability partnership or trust). Accordingly, income of the investment fund, other than the business income, is exempt from tax and income received by or accrued to the unit holders of the Category I and Category II AIFs is chargeable to tax in the same nature and in the same proportion as if it were income received by or accrued to such unit holder had the investment been made directly by him or her. 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 a pass-through status to REITs. Taxes on REITs are imposed in the manner set out below:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>SPV</th>
<th>REITs</th>
<th>Sponsor/Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>DDT of 15% (on gross up basis)</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Interest</td>
<td>No withholding</td>
<td>Exempt</td>
<td>Taxable</td>
</tr>
<tr>
<td>Rental Income</td>
<td>No withholding</td>
<td>Exempt</td>
<td>Taxable</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>N/A</td>
<td>Taxable</td>
<td>Exempt</td>
</tr>
<tr>
<td>Other Income</td>
<td>N/A</td>
<td>Taxable</td>
<td>Exempt</td>
</tr>
</tbody>
</table>

Further, tax implications on 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 is liable to pay dividend distribution tax on the net dividend distributed in the hands of the investee companies.

**Interest**

Interest income is subject to tax in the hands of the Indian resident investors at the rate that would otherwise apply to such investors on their ordinary income. In case of FIIs and FPIs income from interest on income is taxed at 20 per cent. Income from interest on a rupee denominated bond or a government security is 5 per cent.

**Capital gains**

Any short term capital gain arising on transfer of listed shares either on the stock exchange or in an offer for sale is subject to a tax of 15 per cent, provided that the transaction has been subject to securities transaction tax (STT). However, long-term capital gain arising on such a transfer of any shares where STT has been paid is exempt from taxation. If STT has not been paid, 20 per cent tax is levied on long-term capital gains.

**V KEY INVESTMENT TERMS**

With the current government making strides and doling out incentives to attract foreign investments, foreign LPs definitely continue to look at India while making allocations in the emerging market. However, there has definitely been a change in trend around the terms of engagement between the LPs and the GPs. The LPs are acting cautiously, demanding more
rights and subjecting GPs to severe scrutiny. This could be attributed to tepid performance by earlier investments in India managed by such GPs, giving LPs an upper hand in the negotiations.

From a governance perspective, LPs are seen negotiating for roles or representation in investment and advisory committees of the fund. The LPs now want firsthand visibility in relation to the investment or divestment decisions regarding the portfolio investments, as opposed to relying on what is reflected in the reports prepared by GPs. We see a trend where LPs are demanding more control through affirmative rights in relation to determination of the key persons, the composition of the fund team and the investment focus. On the compliance side, LPs are ready to accept only well laid out compliance programmes, as opposed to standard undertakings relating to potential liabilities under their local anti-bribery laws.

Further, LPs are looking to tighten the investment scope upfront and avoid giving flexibility to the fund managers to determine the investment strategy at a later stage. LPs are becoming more hands on and want to put in place mechanisms that help them get involved with the portfolio companies at an operational level.

From a compensation perspective, LPs have started raising concerns over the 2/20 formula for management fees and carried interest that needs to be paid to GPs. The LPs are pushing for management fees to be charged on actual drawdown as opposed to the commitments. With little bargaining power, GPs are now seen offering a discount on the management fee and the carried interest to raise immediate funds. Moreover, with the value of the rupee fluctuating significantly, LPs are demanding a dollar-based hurdle rate from the GPs.

With increased sensitivity towards costs and fees, LPs are seeking approval rights with respect to the operational expenses incurred by the fund over and above any pre-agreed items. Further, LPs are trying to cap the expenses either as a percentage of the fund size or as a pre-agreed number, preferably for the entire life of the fund. Another structure to lower costs that is gaining momentum is entering into managed accounts with GPs.

One of the positives coming out of such a competitive environment is that GPs are being pushed to be more articulate and sophisticated in selling their products to the LPs. A renegotiation of the terms is also paving the way for alignment of interest between the GP and LP, which is *sine qua non* for the success of a fund.

**VI REGULATORY DEVELOPMENTS**

In 2016, the FDI limits were further liberalised in the following sectors, to attract more foreign investment:

- **a** defence (increased from 49 to 100 per cent under the approval route);
- **b** broadcasting carriage services (increased from 49 up to 100 per cent under the automatic route);
- **c** brownfield pharma (up to 74 per cent under the automatic route);
- **d** insurance (increased from 26 to 49 per cent under the automatic route);
- **e** brownfield airport projects (increased from 74 to 100 per cent under the automatic route); and
- **f** private security agencies (up to 49 per cent under the automatic route).
Requirement for prior approval of the RBI for setting up of a branch office, liaison office or project office has been done away with (except for certain sectors). Further, foreign investment is now permitted in trading, including through e-commerce, in respect of food products manufactured or produced in India.

The FVCI Regulations were amended to allow foreign venture capital investors to invest in Indian companies engaged in specific sectors such as biotechnology, IT hardware and software development, and whose shares have not been listed, start-ups and Cat-I AIFs, without the prior approval of the RBI. The AIF Regulations were amended to increase the upper limit for the number of angel investors in a scheme from 49 to 200 to incentivise investments in start-ups. The RBI and SEBI allowed for investment by FPIs in unlisted corporate debt securities such as bonds issued by companies, subject to minimum maturity period and end-use restrictions.

2016 also saw the introduction of the comprehensive Insolvency and Bankruptcy Code, 2015, which consolidates all bankruptcy laws around the insolvency of different legal entities, under one law. It inter alia provides for a new regulator and a seamless and time-bound settlement of insolvency cases and help towards resolving India’s bad debt problems. Various steps have also been taken to encourage investments in start-ups. The government introduced the ‘Start up India Stand up India’ mission in 2016, granting start-ups tax incentives such as 100 per cent deduction of profits for calculating tax for three consecutive years out of five years from the time of incorporation. In addition, SEBI relaxed the rules governing angel funding in start-ups by allowing them to invest in five-year-old start-ups. The lock-in period has been reduced from three years to one year.

Recently, in its budget announcement, the government announced plans to abolish the FIPB in order to cut down on red tape and simplify the foreign investment regime. 2016 witnessed India renegotiating its DTAs with Mauritius, Singapore and the Netherlands (see Section II, supra). Further, in order to implement the anti-avoidance tax regime in India, GAAR is scheduled to be effective from 1 April 2017. The government recently issued the POEM Guidelines to determine the residential status of an entity.

VII OUTLOOK

Undoubtedly, the domestic demonetisation movement in India as well as various recent international factors, including Brexit, the US elections and surging crude oil prices, stunted the economic growth rate in India during the latter half of 2016. These factors, especially the adverse impact of demonetisation on the India growth story, are short-lived and it is only a matter of time before India emerges from this slowdown. In fact, demonetisation has gone a long way to strengthening global investors’ faith in India and its government in cleaning up black money and ensuring fiscal stability, accountability and responsibility. Strong ‘fundamentals’ of India and other initiatives, such as the government’s continuous efforts to liberalise the FDI policy and enactment of the Bankruptcy Code are expected to create a positive outlook for India.

We expect fundraising activity in India to gain momentum in 2017. With the amendments to the tax treaties with Singapore and Mauritius, there are strong reasons to believe that fundraising in India will see domiciling funds in India, as opposed to offshore India-focused funds, while significant tax uncertainty (and Vodafone-type cases) regarding
returns will be a thing of the past. From a sector perspective, we expect investors to continue showing keen interest in real estate, healthcare, financial technology, financial services and consumption.

Lastly, given how intertwined M&A activity, lucrative exits and the capital markets landscape are, we expect fundraising activity to increase, taking its cue from some of the landmark exits of the decade that 2016 witnessed as well as the buzzing (but turbulent) capital markets.
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. 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 of 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 buy-out or venture capital funds, but also infrastructure funds, real estate funds, fund of funds and other funds with special themes are offered in Japan.

II LEGAL FRAMEWORK FOR FUNDRAISING

The legal structures most commonly used as a vehicle for private equity funds offered in Japan have been offshore limited partnerships organised under foreign law, such as the exempted limited partnership under Cayman Islands law, and limited partnerships for investment business (JLPSs) organised under the Limited Partnership Act for Investment Business (Law No. 90 of 1998) in Japan. Historically, private equity funds managed by non-Japanese fund operators have mainly used Cayman Island 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 Island-exempted limited partnerships or JLPSs. These days, an increasing number of Japan-based fund operators are using or considering using JLPSs.
for offerings to investors in Japan and Cayman Island-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 Civil Code (Law No. 89 of 1896). 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 pass-through vehicle for tax purposes. In regard to a 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 the investments which 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 due to this restriction a JLPS cannot be used for private equity funds that invest mainly in securities of non-Japanese companies. In this article, we assume that the subject fund is organised as a foreign limited partnership (foreign LPS) or a JLPS (the terms foreign LPS and JLPS are collectively referred to as ‘LPS fund’) unless we specifically refer 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 forth the rules for securities offerings but also regulates securities brokers and fund managers, is basically applicable if an investor of a fund vehicle is in Japan. As a general rule, a fund manager of a foreign LPS or JLPS will need to be registered as a financial instruments business operator under the FIEA in order to make an offering of foreign LPS interests or serve as the investment manager of the fund’s assets.

i General rules for offering of interests in, and conducting investment management of, a foreign LPS or JLPS

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 a LPS fund solicits investors in Japan to invest in the LPS fund, such general partner, in principle, will 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 will not need 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, in principle, will be considered to be engaging in an investment management business, and thus such general partner will need to be registered as a financial instruments business operator engaging in an investment management business under the FIEA (‘investment manager registration’). Unlike the Type II registration discussed above, the 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.

ii Exemptions from the registration requirements

The FIEA provides several exemptions from the registration requirements discussed above.
QII special business exemption

One of the exemptions used by many general partners is a special exemption from the investment management business registration and Type II registration requirements (the 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, and the general partner meets certain other criteria (the details of which are discussed in Section III, infra). This exemption is only available to the general partner, and is not available to a third party (if any) to which the responsibility for solicitation of the interests in the LPS fund, or the authority to perform the investment management of the fund assets, is delegated. Therefore, if an investment manager, which is not the general partner of the fund vehicle, engages in solicitation activities in Japan, such investment manager will not be able to qualify for the QII special business exemption and will need to obtain Type II registration.

If a general partner qualifies for the QII special business exemption, such general partner must file a notification (Article 63 Notification) with the Local Finance Bureau (and in the case of a foreign general partner, with the Kanto Local Finance Bureau (KLFB)) prior to commencing such business in Japan. Also, the general partner who files the Article 63 Notification will be subject to certain compliance requirements (including appointment of an agent or representative in Japan (in case of 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 and such amendments came into effect on 1 March 2016. The requirements and regulations applicable to the QII special business exemption after such amendment are outlined and discussed in Section III, infra.

Outsourcing of solicitation activities

Although not strictly an exemption from the registration requirements, as discussed above, if a general partner outsources the 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 need to concern itself with exemptions from registration requirements. However, it should be noted that the definition of ‘solicitation’, which triggers the registration requirement under the FIEA, is broad and may include any communication between the general partner and potential investors.

Foreign fund exemption for investment management

For foreign LPSs, there is a special exemption from the investment management registration requirement (the Foreign Fund Exemption). In essence, this exemption is available when: (1) the fund’s direct investors in Japan are limited to QII investors and persons who have submitted a notification under Article 63 of the FIEA with respect to the investment management of the Fund; (2) the fund’s indirect investors in Japan are limited to QII investors; (3) the total number of the fund’s direct and indirect investors in Japan is less than 10; and (4) the amount invested by the fund’s direct investors in Japan is one-third or less than the total amount invested in the fund. In regard to the Foreign Fund 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 of interests in partnerships formed under Japanese law (such as a fund of funds formed under Japanese law including as a JLPS, NK, TK or LLP) who holds 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 registration requirement by outsourcing all of the investment management activities to an investment manager who has investment management registration under the FIEA, subject to certain additional requirements. Such requirements include the filing of a notification by such investment manager, and certain limited information concerning the LPS fund and its general partner is required to 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, 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 the number of investors in Japan who acquire and hold the interests of the partnership as a result of an offering is to be less than 500. As long as the number of investors in Japan who ultimately acquire the interests as a result of the offer is fewer than 500, 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 and provide a document in writing that includes the following: the subject offering meets the requirements for a private placement of the LPS fund interests, and accordingly, is not being registered under the FIEA, and 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 a Foreign LP interests). 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 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 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 such model limited partnership agreement for a JLPS, Japan-based general partners who choose to use JLPSs tend to use such model agreement as the basis for preparing their limited partnership agreements. However, there is an increasing trend to use offshore limited partnerships as an alternative fund vehicle for investments by non-Japanese investors, and when such 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 usually utilise non-Japanese limited partnerships as the fund vehicle 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 businesses covered under the QII special business exemption, ‘specially permitted business’) were significantly strengthened. Many of the compliance requirements, such as adherence to certain code of conduct rules, recordkeeping 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.

i Requirements for QII special business exemption

In order for a general partner to qualify for the QII special business exemption, the LPS fund must meet, in addition to other requirements, the criteria stipulated in items (a) to (f) below; provided, however, that the criteria set forth in items (e) and (f) below only apply if the general partner is seeking exemption from the Type II registration requirements.

- (a) at least one of the investors in Japan, other than the general partner, is a QII;
- (b) the number of non-QII investors in Japan is 49 or less;
- (c) the non-QII investors satisfy certain criteria (non-QII investors that satisfy such criteria, ‘qualified purchaser’);
- (d) 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 less), no non-QII investor is an investor in any of the sub-funds of the fund;
- (e) the offering of the LPS fund interests qualifies as a ‘private placement’; and
- (f) 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 of its interests at once to such person in a single transfer.

ii Disqualifying certain fund operators

Additionally, there are certain disqualification events that apply in order for fund operators (i.e., the general partner) to qualify for and benefit from the QII special business exemption. For example, if the only QII investing in the fund is a JLPS, then, unless such JLPS satisfies a certain asset value threshold requirement, the fund operator of such fund will not be able to qualify for the QII special business exemption. 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 (which is 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 less qualified purchasers, provided certain other criteria are satisfied. Qualified purchasers are specifically listed in the applicable regulation, and include, among others, the following:

- financial instruments business operators registered under the FIEA;
- those having close relationship with the relevant fund operator;
- listed companies;
- corporations whose net asset value or capital is at least ¥50 million;
- subsidiaries/affiliates of (a), (c) or (d) above;
- domestic pension funds and foreign pension funds with investment-oriented financial assets totalling ¥10 billion or more;
- foreign entities;
- individuals with investment-oriented financial assets totalling ¥100 million or more and who have held a securities account for more than one year;
- corporation with investment-oriented financial assets totalling ¥100 million or more;
- general partners of partnerships who hold investment-oriented financial assets totalling ¥100 million or more; and
- foreign funds in the form of partnerships.

iii Filing of Article 63 notification

The general partner of a 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 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 (if the business operation is delegated to a third party, information concerning such third party is to be provided), and in case of a foreign fund operator, the name of its representative or agent in Japan. The Article 63 Notification will also need to include the name of the fund, a brief description of the investments made by the fund and the number, names and types of all of 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 would need to 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

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

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

4 Ibid.

5 Ibid.
operators without an office in Japan are expected to make the necessary public disclosures on their website. The URL address of the webpage where the public disclosures are to be made is also required to be included in the Article 63 Notification to be filed by each such foreign fund operator.

**iv  Application of certain code of conduct rules under the FIEA**

Certain code of conduct rules that apply to firms with Type II registration or investment manager registration status are applicable to fund operators who file 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, prohibited 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 code of conduct rules which 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 such investor is a ‘professional investor’ or non-professional investor. ‘Professional investor’ is defined in the FIEA and includes, among others, a QII, a listed company, a Japanese kabushiki kaisha (a type of company 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 which has filed the Article 63 Notification, and a foreign entity. In addition, the fund operator must notify each professional investor which is not a QII that such investor may choose to be treated as non-professional investor. 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 principal of suitability, and the requirement to deliver a statutory performance report) do not apply in the case where an investor 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. These include customer ledgers, transaction records and copies of certain statutory documents.

New 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 from the end of the fiscal year. The annual business report may be prepared and filed in English.

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 disclosure 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 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 QIIIs 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 of the offices which 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, such fund operator must make the disclosure on a webpage 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 such explanatory document to the public by making it available at its principal place of business and at all of the offices which engage in the specially permitted business, or on the website of the fund operator. The timing and method by which a foreign fund operator is to make such disclosure are the same as those for the public disclosure of matters included in the Article 63 Notification. The explanatory document does not include information contained in the financial statements or information on the rate of return of the fund, and 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 against fund operators who fail to make the required notifications or file false notifications.

IV OUTLOOK

The regulatory environment for fund operators without Type II registration or investment manager registration status changed substantially in 2016 due to the effectuation of amendments to the FIEA concerning the QII special business exemption. Since many fund operators are not yet required to file their annual business reports for the 2016 fiscal year (assuming their 2016 fiscal year commenced prior to 1 March 2016), and the obligation to publicly disclose an explanatory document only arises once an annual business report is filed, the effect of the new requirement compelling fund operators to public disclose explanatory documents has yet to be seen. Also, although Japanese regulators have been actively disclosing names of fund operators who have failed to perform the Article 63 Notification updates required under the FIEA amendments and are conducting on-site inspections of fund operators who have problematic operations, the extent to which the Japanese regulators will actually require and conduct on-site inspections of fund operators generally and/or require submission of reports on the specially permitted businesses (including a report on compliance with applicable legal requirements and obligations) 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. Japanese regulators will likely start exercising their supervisory rights more often to proactively identify violations attributable to problematic fund operators.

Despite the increased regulatory restrictions and requirements imposed on fund operators, the Bank of Japan’s current negative interest rate strategy remains unchanged, and we expect to continue to see strong interests by investors seeking to invest in alternative investments including private equity funds.
Chapter 11

LUXEMBOURG

Alexandrine Armstrong-Cerfontaine

I GENERAL OVERVIEW

2015 was a successful year for fundraising, with a few new players on the market set-up by initiators spinning out of well-known houses to set their fund. There is a vast array of choices for limited partners to invest in new funds, though the number of funds closed last year was slightly lesser than in 2014 according to Preqin (2015: 1,125 funds with, in aggregate, US$550.4 billion raised; 2014: 1,368 funds with, in aggregate, US$551 billion raised). Net assets under management in Luxembourg funds were €3.589 trillion at the close of December 2015. This represents an increase of 13.29 per cent since 1 January 2015 (Alfi, statistics).

In practice, it is very difficult to provide an accurate estimate for the time needed to raise funds, which varies significantly depending on the characteristics of the fund, the track-record of the initiators, commitment sizes, the limited partners’ familiarity with the model of the fund, the investor’s appetite for investing in a particular region, as well as other variables.

Based on the annual statistics of the Luxembourg Commission de Surveillance du Secteur Financier (CSSF), Luxembourg witnesses a diverse initiators base with the following share of the initiator’s location in 2015 comparable to 2014: United States, 21.7 per cent, United Kingdom, 16.6 per cent, Germany, 14.7 per cent, Switzerland, 14 per cent, Italy, 8.7 per cent, France, 7.6 per cent, Belgium, 4.2 per cent, Luxembourg, 2.2 per cent, the Netherlands, 2.2 per cent, Sweden, 1.8 per cent and others, 6.3 per cent). Among the many high-profile and high-value funds set up in Luxembourg, in the pan-European space, PAI VI recently closed its fundraising.

II LEGAL FRAMEWORK FOR FUNDRAISING

Luxembourg offers a wide range of regulated and unregulated investment vehicles, which are chosen by private equity funds on the basis of their investment strategy and their investor base. The number of AIFs set-up in Luxembourg continues to increase and Luxembourg remains the second largest global leader for domiciled funds, behind the US. Luxembourg is also gaining a significant ground against offshore centres.

1 Alexandrine Armstrong-Cerfontaine, who was a managing partner at King & Wood Mallesons when she wrote this chapter, is a consultant at Goodwin Procter LLP. The information in this chapter was accurate as of March 2016.
There is a vast array of legal forms and structuring options available to initiators and over 80 per cent of the funds set-up for private equity houses are unregulated funds, benefiting either directly or indirectly (through a tax blocker) from all EU directives, particularly the Parent-Subsidiary Directive, and also from double tax treaties signed by Luxembourg. The most commonly used forms of non-regulated vehicles currently are (1) the common limited partnership (with legal personality, SCS) and (2) the special limited partnership (without legal personality, SCSp). Whilst available in principle, popular forms prior to the enactment or the AIFM Law are much rarer nowadays, as they do not offer the level of flexibility of the Luxembourg partnerships. In other words, the following unregulated structures are considered only to the extent that a Luxembourg partnership cannot be used for a fund.

These forms include:

a. the private limited company (SARL);
b. the partnership limited by shares (SCA), which requires at least one general partner with unlimited liability to be in charge of the management, and one limited partner with limited liability who cannot be involved in the management of the SCA; and
c. the public limited company (SA).

The reason of the success of the limited partnerships is due to their key features, as set out below:

a. Confidentiality is guaranteed, as the registration of the SCS/SCSp at the Luxembourg trade and companies register (RCS) is minimal and includes their name, the name of their general partner(s) (GPs), their object, their address and their duration. Furthermore, the performance of the SCSp remains entirely confidential, as the SCSp’s accounts are not filed at the RCS.

b. Limited partners have a safe harbour for actions taken in respect of the limited partnership. In Delaware and the Cayman Islands, the scope of decisions made by limited partners without compromising their limited liability is uncertain. In Luxembourg, the Act dated 10 August 1915 on commercial companies, as amended (the Companies Act) introduced a non-exhaustive list of actions that may be taken by LPs, which do not, as such, put their limited liability at risk.

c. Wide choices for contributions are guaranteed as contributions to an SCS and SCSp may be made in kind, cash or industry and may include loans granted to the partnership, with no debt-to-equity ratio to be complied with. A mere statement in the limited partnership agreement (LPA) by the partners suffices for non-cash contributions. Contributions, withdrawals, loans, allocations to profits, losses and expenses may be booked for each limited partner in a capital (and loan) account.

d. GP and LP’s creditors cannot seize the SCSp’s assets, because the assets contributed to the SCSp are registered in the name of the partnership and may only satisfy the rights of creditors that have been created in relation to the SCSp’s business and the SCSp’s assets are not available to the GPs or the limited partners’ creditors.

e. Investors benefit from a high flexibility on power and economic distributions, with limited or multiple as well as non-voting partnership interests (which may be represented by securities issued by the SCS/SCSp), thus enabling investors to distribute powers as they deem fit in the LPA. In addition, there is no clawback on distributions in case of insolvency, except for fraud as opposed to the British Virgin Islands, where a six-month clawback period applies.
The LPA sets out all conditions relating to the redemption, transfer, splitting or pledge of their interests by the LPs. The Companies Act provides conditions to transfers if such transfers are not dealt with in the LPA. The Companies Act also provides that partnership interests may be listed on a stock exchange or a regulated market.

The following vehicles are supervised and authorised by the regulatory authority, the CSSF (www.cssf.lu). Their launch does require more time than unregulated vehicles given that the visa of the CSSF must be obtained. Therefore, the products below are only considered in light of the investor base, that would require an investment into a regulated entity.

a SICARs, which have been implemented to offer a new lightly regulated vehicle for investment in private equity to well-informed investors. They combine a flexible corporate structure for investing in risk capital, with the benefits of light supervision by the CSSF and a neutral tax regime. All the corporate forms available in Luxembourg (including, for the avoidance doubt, the limited partnerships) may be used to set up a SICAR, these various possibilities offer significant freedom to initiators.

b SIFs, products that aim to be an attractive vehicle through their flexible functioning rules, and the extensive scope of assets open to investment. A SIF can be used to invest in any kind of assets without limitation, to the extent it complies with the general risk spreading rules. It is authorised and supervised by the CSSF, and the process of authorisation is usually shorter than for that of a SICAR.

c FCPs, which are mutual funds that are contractual arrangements without legal personality, subject to the prior authorisation and supervision of the CSSF.

Regarding the key legal terms negotiated with investors, much will vary depending on the track record and size of the fund. Based on a sample of large buy-out funds raised in the last two years, or currently fundraising, the general position is that the market is becoming more favourable to general partners so that they can improve their terms, sometimes significantly. Obviously, all of this is dependent on the particular dynamic of the fund, the base position (whether GP friendly or not) and the particular level of interest from investors. At the same time, investors have also achieved some tightening in specific areas, for example compensation for the general partner following its removal and some of the corporate governance protections for funds generally, particularly around rights of the advisory committee.

Despite the recent trend in the market for longer term funds, in the large buyout space the vast majority of funds are still 10 years either from the first or final closing date. There are then typically two possible extensions of one year each. In some cases the first extension can be at the manager’s discretion, but in the vast majority of our sample both extensions either require advisory board consent or often an investors’ 50 per cent consent.

Multi-asset managers in our analysis are focused on maintaining a flexible and light-touch restriction on the ability to raise a successor fund or other business lines. There are a number of components to this term:

a scope of restriction: most managers are only restricted from making investments through the successor fund, which gives them the ability to market and raise the new product;

b type of product: a majority of the managers are only restricted with respect to another pooled investment vehicle, but in some cases the restriction may extend to managed account mandates or any other way of arranging transactions;
c degree of overlap with current fund: the successor fund provisions typically only apply to a new product that is substantially similar to the current fund. In some cases this includes geographic scope, but more typically this is focused on investment criteria and objectives; and

d trigger for lifting restriction: in an overwhelming majority of the funds, the end of the investment period lifts the restriction. Typically, managers also have the flexibility to engage with new products once the current fund is 75 to 80 per cent utilised. There is some variance in the market on what constitutes utilising the current fund. Typically though, this refers to amounts actually drawn down or reserved (for investments, follow-ons, expenses or fees).

Investors have focused recently on the ability of a fund to invest outside of its core area. This is often limited to 20 per cent of commitments although in some cases this restriction may be higher or lower, typically in the range of 15 to 30 per cent. The definition of whether an investment falls within the fund’s core area is also important, in some cases referring to the business having a headquarters or a material part of business in the region that is relatively wide or in other cases referring to significant operations in the region. More restrictive definitions include a requirement that the undertaking has to have headquarters situated in the core region or a majority of its assets and profits within that region.

The majority of large buyout funds are charging management fees of 1.5 per cent of total commitments during the commitment period. There are very few funds that have managed to retain a management fee greater than 1.5 per cent during the commitment period. There is a broader range in the management fee rates being charged post commitment period (step-down period). The range is more evenly spread between 0.75 to 1.5 per cent of acquisition cost less write-offs (some funds have managed to exclude write-downs). Since the financial crisis, early bird discounts have become less prevalent than they once were and they are only seen in a smaller number of funds in our sample. We are also seeing volume discounts being utilised. Furthermore, there are some alternative mechanisms for calculating management fees that we have seen. Depending on the type of carried interest, we have seen a recent trend in funds where the management fee varies depending on the optional type of carried interest model available and applied to a particular investor.

At the larger end of the market there has not been much change in the general position that 100 per cent of transaction fees are offset against management fees. Almost all funds have a 20 per cent carried interest rate and provided for some form of clawback. Typically this was an end of life clawback to ensure that investors had received the lesser of their drawn commitments plus preferred return and their agreed share of profits (80 per cent). Some funds, in particular those with deal-by-deal carry, have clawback guarantees (from the house or carry recipients) or rolling clawbacks, usually on specified anniversaries of the final closing date, or both. At the GP-friendly end of the market, many funds have avoided an escrow on the basis of the clawback (although additional guarantees or rolling clawbacks would generally be required), but where there is an escrow provided for it typically only provides for a drip-feed allocation of carry once sufficient amounts have been retained to cover repayment of all investors’ drawn commitments, preferred return and undrawn commitments.

As regards key investor protections trends, with no fault provisions, voting thresholds are usually 75 per cent, whereas for fault provisions only a simple, or occasionally two-thirds, majority is typically required. We have tended to see the pendulum swing in favour of investors in relation to no fault removal provisions. There are a number of strategies for mitigating
this and some funds have negotiated grace periods of between one and three years and compensation of typically one, but in exceptional cases two, years’ management fees. Since it is a relatively easy protection for investors to trigger, some funds have successfully avoided giving investors the right to suspend or terminate the investment period without cause. A key feature of the investor protections is the treatment of carried interest following removal of the general partner or termination of the fund. As is to be expected, the provisions following no fault removal or termination are more generous and in the overwhelming majority of cases general partners are permitted to retain all the carried interest from investments made prior to the no fault event although in some cases this is valued at the removal or termination date. Some have managed a more favourable position and have an additional right to be paid in priority to other investors. On a fault removal or termination, the carried interest treatment is generally much more investor friendly. In this scenario, the best case position for a manager is to be able to retain carried interest on investments already made prior to the cause event, but in many cases investors have successfully achieved various haircuts, up to 100 per cent although this is unusual.

The Luxembourg regulator brought clarity to distribution and solicitation. The definition of ‘marketing’ in Article 1(9) of the AIFM Law is ‘a direct or indirect offering or placement, at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the EU’. Marketing within the meaning of the AIFM Law takes place when the AIF, the AIFM or an intermediary on their behalf seeks to raise capital by actively making units or shares of an AIF available for firm purchase by a potential investor. This does not require that an investor subscribes or commits. Making available the territory of Luxembourg documentation that can be used by prospective investors to formally subscribe or commit to subscribing shares or units of the AIF is considered marketing.

The presentation of draft documents or final documents prior notification of marketing by the AIFM (or prior final authorisation for Luxembourg-regulated structures) does not qualify as marketing, provided that no documents allowing for a subscription or commitment are handed out and that no subscription or commitment in the relevant AIF may become effective until and unless the CSSF is informed. The presentation of such draft documents at the initiative of the AIF, the AIFM or an intermediary appointed by them shall no longer allow the benefit of reverse solicitation by the prospective investors to whom they have been presented.

Lastly, it should be born in mind that the general partner owes fiduciary duties towards the fund, as does the AIFM. This may raise issues of conflict of interest, which are addressed by not taking part in the relevant deliberations and submitting this to the approvals of limited partners, it being understood that LPAs do provide for conflicts.

III REGULATORY DEVELOPMENTS

Unregulated funds are generally not subject to regulation and CSSF supervision. Their AIFM, if authorised, is supervised by the authority of the jurisdiction where it is located. If the AIFM is based in Luxembourg, and if the AIFM is authorised (as opposed to the registration regime for sub-threshold assets under management), the AIFM is supervised by the CSSF. As mentioned above, SICARs, SIFs and FCPs are supervised by the CSSF. There is no requirement of registration of the sponsor and the CSSF does not supervise the fund raising process and investor base of unregulated funds.
It should be noted that the bill of Law 6929 (the Bill) regarding reserved alternative investment funds (RAIFs) has been published on the Luxembourg parliament’s website. This is a major reform that will be welcomed by the funds industry as it tackles the overlayering of supervision that came to existence with the enactment of Luxembourg act of 12 July 2013 on alternative investment funds managers (the AIFM Law). The Bill also facilitates a process to establish regulated funds: RAIFs, which will have a legal regime close to the regime of specialised investment fund (SIFs) without the supervision of the CSSF.

The SICAR was invented as a vehicle promoting investment in companies for the purposes of their development. As an incentive, a favourable tax regime applies to SICARs. A SICAR incorporated as a company is subject to regular corporate income tax, but any gains or proceeds received that derive from investments in risk capital are tax exempt. SICARs established as the SCS/SCSp are tax transparent and therefore not subject to tax in Luxembourg, except for the municipal business tax. The SIF is not subject to tax, apart from a registration tax of 0.01 per cent on the net asset value per annum.

Unregulated funds are structured to benefit from the participation exemption regime, which provides that if certain holding thresholds (percentage or value) are fulfilled, dividend payments and capital gains are tax exempt. In addition, Luxembourg has a far-reaching network of treaties avoiding double taxation.

The taxation of investors depends on the competent jurisdiction for each manager or board member. Specific tax consequences must be considered for each investor (depending on his jurisdiction of residence) before purchasing shares or divesting shares. Transactions should respect the arm’s-length principle.

Regarding the management team, it should be noted that, alongside the AIFM Law, a new carried interest regime was implemented in Luxembourg. Taxation of the carried interest paid to Luxembourg tax residents who are employees of AIFMs is, provided that certain conditions are met, taxed at a rate equal to a quarter of the global standard income tax rate.

All in all, the tax, legal and regulatory landscapes shifted significantly for European private equity fund managers and investors in 2015. Some positive initiatives emanating from the European Commission in particular have been welcome. The positive developments started early in 2015, when the European Commission set out its plans for a Capital Markets Union (CMU) across Europe. It published a consultation paper first, and then an action plan pledging to pursue various disparate initiatives. It was significant that the Commission highlighted the important role that private equity and venture capital had to play in creating a single market for capital, and announcements throughout the year – such as the introduction of ELTIFs, a new type of regulated fund that can be used to access retail investors; a review of EuVECA, the ‘AIFMD light’ regime for smaller managers and the recent announcement of a review of the prospectus regime – are all positive steps.

However, the fact that many Member State regulators demand fees and forms before a fund can be marketed using the AIFMD passport continues to undermine the single market. And more progress is needed on the plans for a ‘third country’ passport, designed to allow non-EU managers to opt in to the AIFMD and market freely throughout the EU.

The issue of remuneration under the AIFMD, which was thought to have been settled, reappeared during the summer, as a consultation was launched on remuneration under the UCITS V and AIFMD; this may cause headaches for management teams.

Perhaps the biggest announcements of 2015, and potentially the most unhelpful, have been tax related. The OECD has continued with its wide ranging ‘BEPS’ initiative, and the private equity and venture capital industry will be particularly interested in the proposals on
treaty abuse and interest deductions. In the UK, there have been several other tax changes, and announcements of changes to come next year. Although the government has repeatedly stated that that its intention is to preserve the tax treatment of ‘carried interest’ and funded executive co-investment for private equity capital funds, the complexities of the new rules mean that some uncertainty has been introduced on how receipts by fund managers and their executives are taxed, and this has an impact on the structuring of funds in Luxembourg.

**IV OUTLOOK**

There have been developments in relation to structures throughout Europe following the introduction of the Luxembourg limited partnership (with or without legal personality) in 2013. France has created a new type of fund vehicle, designed to be a competitor to the English and Luxembourg limited partnerships, though it is fair to say that the features of the French product are not challenging the flexible and attractive multiple options Luxembourg has to offer with the revamped partnerships. To date, no pressure has been felt in Luxembourg due to the French reform. Luxembourg will also look for the long-awaited amendments to UK limited partnership law, to bring the product closer to vehicles in Luxembourg, the Channel Islands and Delaware. Luxembourg’s pragmatic approach to the activities a limited partner may carry out without jeopardising its limited liability is a huge advantage in comparison with many other jurisdictions, and does play a role in the choice of the location of the establishment of a fund.

In 2016, transparency will be high on the agenda for both investors and managers but standardised reporting may be difficult to implement across the whole industry, with the guidelines of the EVCA (now named Invest Europe) providing for a little more flexibility. Also included in the Invest Europe Handbook will be the newly updated IPEV valuation guidelines (when finalised). The proposed changes to the guidelines are not major but they have been restructured and contain helpful clarifications.

Overall, 2015 has been an eventful year for the private equity industry. Those with a legal or compliance role have been very busy and will continue to work hard in 2016. 2015 has also been a strong year for fundraising and there are some positives to take from various initiatives at a European level. 2016 may see more clarity on how non-EU funds and managers will be able to access the AIFMD and its marketing passport, and could bring further helpful initiatives as the European Commission continues its bid for a Capital Markets Union, but there is still much uncertainty on the future of the regulatory landscape.
Chapter 12

MEXICO

Hans P Goebel C, Héctor Arangua L and Adalberto Valadez

I GENERAL OVERVIEW

Over the past 15 years Mexico’s private equity (PE) industry has raised over US$42.571 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. Currently, the number of active fund managers has reached over 168 active GPs from diverse sectors, growing sevenfold since the beginning of such industry in the early 2000.

The past three years gave way to the actual implementation of the first steps of the structural reforms approved by Congress in 2013, and Mexico is now about to experience the harvest of such legislative endeavours. In 2015, Mexico surpassed Brazil becoming the most popular destination for country dedicated private equity vehicles in Latin America. According to the Emerging Market Private Equity Association (EMPEA), Mexico dedicated private equity vehicles went from raising a modest US$152 million in 2008 to US$2.1 billion in 2015. Also, a survey from Coller Capital and Latin America Private Equity and Venture Capital Association (LAVCA) conducted among Latin American and International LPs, shows that Mexico is the country with the best risk to return ratio compared with other Latin American countries.

Mexico is showing a positive macroeconomic outlook with an approximate annual GDP growth rate of 2.5 per cent between 2013 and 2016. According to PRO México Trade and Investment, Mexico is one of the world’s most globalised countries, with 10 free trade agreements spanning 45 countries, nine partial scope and economic complementation agreements within the framework of the Latin-American Integration Association (ALADI) and it is a member of the Trans-Pacific Partnership Agreement (TPP), and 32 reciprocal promotion and protection of investments agreements with 33 countries. Mexico’s diversified export line is ranked 13th in the world and it is the seventh-largest car manufacturer in the world.

In recent years the Mexican government has been an important player in the PE industry, investing in more than 71 funds through institutional investors such as Nacional

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1 Hans P Goebel C, Héctor Arangua L and Adalberto Valadez are partners at Nader, Hayaux y Goebel. They would like to thank and acknowledge Ms Lorenza Molina, associate at the firm, for her help with the preparation of this article.

2 AMEXCAP, ‘Overview of the Private Equity Industry in Mexico – June 2016’.


Financiera, FOCIR and Bancomext, among others, through the fund of funds investment vehicle Mexican Corporation of Equity Investments (CMIC). In addition, the National Institute of Entrepreneurship (INADEM) has helped the Mexican venture capital industry (VC) 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 pesos targeting one fund with an approach to the Asia-Pacific alliance countries. Finally, domestic pension funds (AFOREs) have played a determinant role in the growth of the PE industry, having contributed with more than US$7.8 billion through 64 capital development certificates (CKDs) since 2009. This amount can further increase up to US$13.6 billion if outstanding capital calls are considered.

In general, information about PE funds is not publicly available during the fundraising stage, unless such funds are public funds raised in the securities market, such as CKDs or Mexican real estate trusts (FIBRAs).

The recent reforms are having a positive impact on the Mexican PE industry. Only within VC, Mexico has witnessed the number of GPs tripled in the past five years; infrastructure and energy funds have also increased significantly reaching 30 funds on 2016, a clear effect due to the energy reform that is allowing private investments on energy sectors, oil and gas, electric power generation and renewable energy.6

The Mexican fundraising market has been, since 2014, in an upward trend. In the past years the most attractive sector has been real estate, but recently the VC sector is clearly 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 and technology, real estate funds mainly target the industrial, commercial, tourism and housing sectors, and the infrastructure and energy funds are currently concentrated in the oil and gas sector.

The current government (which came into office in late 2012) is still focused on the implementation of the reforms stemming from the Pact for Mexico. The Pact for Mexico comprises several subjects and items, mainly regarding the economy, anti-corruption, transparency and improving the Mexican rule of law. Regarding these, many legal reforms to the economic sector have been approved and enacted, such as reforms to the legal frameworks for the following sectors: labour, telecommunications, finance, tax and energy.

The energy reform, one of the most significant reforms in Mexico, which ended a 70-year chapter of restrictive laws in the oil and gas and electricity sectors, as well as the state monopoly on oil and gas production and in the electricity sector, has opened the investment and participation of private and foreign companies, including PE funds, in such 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 in order to ensure gas supply for power generation. The pipeline network is expected to increase from 11,126km in 2012 to 20,895km in 2019. As of March 2016, there are approximately 20 CKDs that invest in the infrastructure and energy sectors that have risen over 80,500 million pesos.7

This constitutional and statutory reform is restructuring (some say creating) the Mexican energy industry, setting forth 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

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6 Idem.
7 Idem.
industry are considerable, especially now that the attention is shifting to its implementation. PE funds will be able to invest in the oil industry by investing in, or lending to, companies or consortia 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. Considerable opportunities will also arise in any business relating to companies participating in midstream and downstream activities, such as petrochemicals and other transformations of hydrocarbons, and the transportation of oil and gasoline. According to AMEXCAP, Mexico’s oil and gas value chain could require between US$300 and US$400 billion dollars in capital expenditure through to 2020, promoting a considerable inflow of outside capital and creating an estimated 2 million jobs by 2025.8

Industries are changing and Mexico’s global competitiveness is increasing, reforms and governmental initiatives are modifying the structure of the economy to attract investments. The outlook is for Mexico to become a sophisticated design and manufacturing centre and not only a low-cost producer. A clear example is the state of Queretaro, which is growing into a new centre for the aerospace industry, with dozens of multinationals setting up shops in the state’s industry zone making the most of generous subsidies offered by the government. At the centre of this growth is Queretaro Aerospace Cluster, whose clients include Safran, Airbus, Delta and Bombardier.9

Private investment into Mexico’s energy infrastructure industry will experience strong growth as the energy reform’s measures begin to take hold; many other opportunities will also arise regarding electricity production projects (mainly combined-cycle gas plants and renewables) both for general and private consumption. 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; for example, Canadian energy firm TransCanada was awarded a US$550 million contract to construct a 420km gas pipeline from Tula in Hidalgo State to Villa de Reyes in San Luis Potosi. This adds to their midstream holdings in the country (which include a contract to build the US$500 million Tuxpan-Tula pipeline). A strong year is expected in the oil and gas pipeline industry through 2017, when a number of major projects will reach completion, for example the wind farm project ‘Tres Mesas’ carried out by the Spanish company Abengoa with a US$300 million investment.

The Mexican PE market has grown considerably over the past 16 years. The above-mentioned reforms, their proper implementation and a solid economic foundation will likely foster the growth of Mexico’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 US), but also because of the number of trade agreements the country has in place, making preferential relations with 44 countries possible; a growing workforce; and fiscal prudence.10 We believe more firms will come to Mexico and benefit from such favourable conditions, and will continue to elevate PE fundraisings and to profit from the incentives arising from the newly structured legal frameworks, as seen during 2015 and 2016.

In connection with the foregoing, Mexico’s government introduced in 2015 two new investment instruments that will be used to promote Mexico’s economic development and in

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8 Rosenfel E, ‘Mexico to receive major economic jolt’, CNBC.com, 2014.
10 ‘Private Equity in Mexico: Primed for significant growth’; Antonio Martinez Leal and Pino del Sesto, Bain and Company.
particular to boost the PE industry. In September 2015 the creation of ‘FIBRA E’ also known as the ‘Mexican MLP’ was announced. 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. FIBRA E will allow 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. Certain amendments were made to the applicable regulations in April 2016, in order to make the instrument more appealing.

In December 2015, the investment project certificates or CERPIs were introduced. CERPIs will allow insurance companies, pension funds (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.

As to the reception by potential limited partners of PE funds in the pipeline, public Mexican funds such as CKDs and FIBRAs will likely be received favourably by Mexican institutional investors (mainly Mexican pension funds) if the projects are adequately structured and follow the standard market terms and economics of such funds. As to private Mexican funds, their success will likely depend on the recent success and market credibility of the sponsors or GPs of such funds. As for the newly introduced FIBRA E and CERPIS, they had their first issuances taking place at the end of 2016, reflecting the industry’s appetite for financing new projects within the asset class.

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 such fund may range between six to 12 months. For purposes of clarity, PE funds are generally structured as a CKD (and as of 2016, CERPIs) to allow them to raise commitments from the Mexican pension funds (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 Exchange (BMV) and managed by fund managers (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 56 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.

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 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.

The Mexican VC has grown significantly reaching US$1.59 billion in accumulated committed capital for the last 16 years.11 Mexico’s VC sector is now an attractive market in which to invest; the Latin American Private Equity and Venture Capital Association’s

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latest survey reveals that limited partners have invested 248 per cent more in Mexico than in previous years. Mexico’s VC industry has 57 active fund managers, and 40 foreign GPs who performed at least one transaction in the last four years. In the same line, AMEXCAP registered 522 VC transactions from 2010 to September 2016 and, on the liquidity side, noticed 21 exits.

Below are recent deals that were made publicly available.

In September 2016, Mira Manager, S de RL de CV, held the issuance and placement of the first CERPI for a maximum amount of 4 billion pesos on the BMV. This CERPI is aimed at developing medium to upper class housing, commercial stores, offices and hotels.

In October 2016, the first public offering of Fibra E investment securities in Mexico by local construction company Promotora y Operadora de Infraestructura (Pinfra), raised 11.8 billion pesos in total. The securities, issued through Fibra Vía, a financial vehicle created by Pinfra, sold at a price of 30 pesos each. Through the placement, Fibra Vía will now own 44.4 per cent of Pacsa, the company operating the Mexico City-Toluca highway, while Pinfra will hold a 53.6 per cent stake in Fibra Vía. The Mexican construction company will retain 79.4 per cent of Pacsa’s shares. Pinfra said that around 80 investors participated in the offering, including retirement fund administrators (Afores), and pension and investment funds. This was the first time in Mexico that a company issued Fibra E securities since the government introduced the tax-efficient instrument last year in order to promote energy and infrastructure projects.

Accel Partners and QED Investors made their debut investments in Mexico. Accel participated in a US$6.7 million Series A in Mexican grocery shopping service Cornershop led by ALLVP, with participation from Jackson Square Ventures, Endeavor Catalyst, and Nordic firm Creandum. QED Investors joined Accion Frontier Inclusion Fund, KaszeK Ventures, Quona Capital, and Jaguar Ventures in a US$8 million Series A in Mexican lending platform Konfio.

InnovaCamp Ventures launched a 125 million peso fund to invest in Mexican start-ups in the food industry over four years.

Affiliates of ACON Latin America Opportunities Fund IV have made an investment in Controladora GMI, a manufacturer and provider of modular construction solutions in Mexico and Latin America serving the aeronautical, education, housing, retail and industrial sectors.

Orange Investments, an investment firm focused on real estate investments in Mexico, seeks to capture up to 5 billion pesos with the issuance of its first CKD vehicle in 2017.

Miami based private capital firm Alsis has committed to investing in the Mexican housing sector. Alsis is backed by Canadian and American firms Ontario Teacher’s Pension Plan (OTPP), the California Public Employee Retirement System (CalPERS), and private equity and venture capital firm, Northgate.
Mexican private equity firm Walton Street México will invest 1.4 billion pesos in real estate projects in Mexico. The funds for the investment were raised from the issuance of the firm’s fourth CKD.19

In December 2106, Nexxus Capital announced that it has reached an agreement to invest in Pumping Team Holding SA de CV a holding company of concrete pumping services with operations in Mexico and Spain. This investment will be made through Nexxus Capital Private Equity Fund VI, LP and Nexxus Capital VI Trust, once certain closing conditions are met, including the approval of Mexico’s Antitrust Authority. The transaction involves the Spanish PE Fund MCH Iberian Capital Fund IV, FCR, and the shareholders of Pumping Team SLL who will be the operating partners of the company. This will be one of the first transactions that combine both Mexican and international PE Funds. Pumping Team will have nearly 550 pumping units, considering the existing operations in Spain as well as the units acquired by one of the Mexican subsidiaries of CEMEX SAB de CV.20

IGNIA, a leading venture capital fund is raising its second fund to continue investing in high growth enterprises, which targets 70 per cent of the population at the base of the socio-economic pyramid of Mexico21 and announced their investment in Abra, a bitcoin-blockchain-enabled mobile wallet and payments company based in Mountain View, California. Mexico is a key market in Abra’s international expansion efforts; the Company plans to grow rapidly in the country in partnership with IGNIA. Through this investment, IGNIA reasserts its confidence in Mexico’s growing fintech sector and reaffirms its commitment to invest in innovative solutions that foster financial inclusion.

II LEGAL FRAMEWORK FOR FUNDRAISING

The Canadian limited partnership is one of the most popular legal forms to structure PE funds with Mexican limited partners investment, as they are considered transparent structures for tax purposes. In addition, other forms of vehicles used in Mexico include the PE investment trust and FICAPs, which is 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 (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 FICAPs is that the trust is subject to a transparent regime for tax purposes, and thus such regime allows the investors to directly recognise the income generated through the trust (dividends, capital gains and interest payments) as if they had obtained such 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).

19 Idem.
21 Idem.
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 2015 transactions range between 1.5 and 1.75 per cent of the total amount invested during the 2014 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 Mexican Securities Market Law; all items not covered by the Mexican Securities Market Law are regulated by the General Law of Business Organisations. However, the SAPI is not subject to obligations applicable to public corporations or to the surveillance of the National Banking and Securities Commission. Therefore, no disclosure obligations must be met.

PE funds are reluctant to share information due to 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 its 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 private placement of securities to such investors. For public funds such as CKDs or FIBRA, solicitation is open to the general public (any kind of investor, person or entity, whether Mexican or foreign), although generally such funds target the investment of institutional investors such as the Afores, insurance companies and sophisticated investors who are private banking clients. Public funds such as CKDs and FIBRAs are also subject to certain solicitation and publicity guidelines applicable to all issuers on the BMV 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) shall be set forth contractually. Furthermore, the adoption of the Better Corporate Practices Guidelines issued by the Mexican Coordination Business Council is encouraged, and many funds have adopted such practices regarding corporate governance and fiduciary duties.
Regarding CKDs 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; such 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 or FIBRAs are subject to the same fiduciary duties that the directors of Mexican public companies are subject to in accordance with Mexican securities law.

Regarding FIBRA E, it 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 the FIBRAs with certain differences. The trust must have (1) up to 30 per cent of its book value represented by bonds of the federal government or shares of mutual funds who may invest only in fixed income securities, and (2) at least 70 per cent of its book value represented by investments in shares of Mexican companies. Such Mexican companies shall comply with the following: (1) the shareholders of the company (other than the trust itself) must be Mexican residents; 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 such 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 only 25 per cent of the book value may be represented by new assets.

III REGULATORY DEVELOPMENTS

Except for publicly placed PE funds (such as the CKDs, FIBRAs, FIBRA E 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 E and CERPIs are governed by federal securities law, and their main regulator is the Mexican Banking and Securities Commission or (CNBV). CKDs, FIBRA E, FIBRA E, 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 such requirements are met, the limited partnership will be treated as 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 such 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 such investors (e.g., institutional, foreign or local, tax-exempt or taxable).

To qualify as such, FICAPs are subject to certain requirements under Mexican tax provisions:

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 following the end of the tax year. If the FICAP does not reach such thresholds, it will not be considered as such and thus will not benefit from the specific tax rules applicable to such vehicles.

Slight changes were made to the tax regime applicable to FICAPs for 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, such 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 in order 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 by government reforms and policies, a stable macroeconomic situation, a stable population growth rate, real income increase and an active entrepreneurial ecosystem. New and different investment vehicles are drawing in Mexican investors, and foreign LPs are increasing their participation. Further, innovative instruments such as the FIBRA E promise to power private investments.

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 and energy industries. If conditions remain the same and the growth rate remains at levels we have seen, the PE industry would reach US$80 billion by the end of 2020 according to AMEXCAP.

We predict that the regulations applicable to publicly issued PE funds will continue to be improved, and that the regulations regarding investment restrictions applicable to Mexican pension funds must necessarily evolve toward the type of regulation seen in other, more evolved countries in order to allow the pension funds to conduct private transactions and investments in funds or projects directly (and not only through publicly issued securities such as CKDs, FIBRAs, FIBRA E and CERPIs).
Chapter 13

NORWAY

Klaus Henrik Wiese-Hansen and Stig Nordal

I GENERAL OVERVIEW

i General activity in the Norwegian private equity market
Norway experienced less growth in 2016 than previous years, due to the significant turmoil in the energy sector, with falling oil prices, fewer investments in the sector and cutbacks in some large firms. The GDP Growth Rate was negative in Q2 and Q3 2016 but positive from Q4 2016 until Q1 with 1.8 per cent.2

The pipeline for IPOs, capital market transactions and other deals in 2016 reached approximately the same level as in 2015. Despite the general turmoil caused by the fall in oil price in 2015, Oslo Børs performed relatively well in 2016, with a 12 per cent gain in the Oslo Børs Benchmark Index. Oslo Energy Index was up with 31 per cent in 2016, while companies in the consumer industry performed well.3 Worth mentioning is that Oslo Børs opened a new market place in 2015, Merkur Market, making it possible for smaller companies to be listed on a Multilateral Trading Facility (MTF). By the end of February 2017 there have been 14 listings on Merkur Market.

In the private equity market we saw some strong exits in Norway in 2016. The most notable exits in 2015 were Altor and Bain Capitals sale of EWOS in a transaction that valued EWOS to €1.35 billion. Also worth mentioning is EQT’s sale of its remaining shares in the Norwegian sports retailer XXL.

ii The current Norwegian private equity fundraising market4
During the past 10 years, the Norwegian private equity market has increased its assets under management significantly, with Norwegian funds over €10 billion in that period. While the fundraising levels in 2012 and in the first three-quarters of 2013 were disappointingly low, the fundraising levels increased significantly from the Q4 of 2013, throughout 2014–2016. In fact, 2014 and 2015 had the highest fundraising activity level in any year on record.

The fundraising activity in the rest of the Nordic countries was good in 2015 and 2016, much due to the closing of EQT Fund VII of €6.75 billion. The Norwegian state-owned private equity fund manager Argentum was one of the investors in the fund. This fund is the largest private equity fund ever in the Nordic region. Nordic venture funds raised nearly €280 million in 2015, and continued at the same level in 2016, with a relatively strong

1 Klaus Henrik Wiese-Hansen and Stig Nordal are partners at Advokatfirmaet Steenstrup Stordrange DA.
2 Information from Statistics Norway.
3 Information from Oslo Børs.
4 All of the information in this section is drawn from reports by Argentum, NVCA and The Nordic Web.
pipeline. It is also worth mentioning two new seed-funds backed up with public funds in a 50/50 partnership with private investors, located in Bergen and Tromsø, which have started investing in 2016.

It seems important for a successful short fundraising process that the management team of the funds have solid track records from managing previous funds. It also seems easier to raise funds in the buyout segment than in the venture market. The greater risk connected to the venture market plays a role in investors’ assessments of investment cases. The two new seed funds indicate this, where private investors are offered a risk reduction of 15 per cent from the state.

To sum up, going into 2017, the picture of available private equity capital is positive for Norway within the buyout and venture segment.

With regards to the earliest stage or pre-seed stage in a business life cycle, there has been a significant shift in available capital in 2016 and into 2017. StartupLab, connected to the University of Oslo, raised its second fund; Founders Fund II AS in 2016, to support the earliest stages in the ICT and technology sector. Such initiative is also seen in other sectors, where several investors and corporates have invested in early stage or pre-seed companies. In Norway, there has been an incredible rise in pre-seed and seed investments in 2016, totalling 78 investments at nearly US$200 million, which represents an increase of 160 per cent in the number of investments.

In the buyout segment, the activity decreased in the Nordics in 2015 and 2016. Despite the low activity there were some successful exits. Altor and Bain Capital sold the Norwegian fish feed producer EWOS to Cargill, in a transaction that valued EWOS at €1.35 billion.

II LEGAL FRAMEWORK FOR FUNDRAISING

i Preferred jurisdictions and legal forms for funds

Since the early 2000s, the Norwegian private equity market has seen a considerable growth in the number of private equity managers, funds and assets under management. Regardless, the Norwegian private equity market is still a young and, in relative terms, small market. While the European Venture Capital Association was established in 1983, it took another two decades before the Norwegian Venture Capital Association (NVCA) was established, in 2001. At that time, the members of NVCA only had (approximately) €900 million of assets under management. Today, the association’s members manage around €10 billion in total, spread unequally between 107 different funds.

As is evident from the above, the Norwegian private equity market has seen a considerable growth in the number of funds and assets under management, and in levels of professionalism, not least among the larger private equity houses that operate in an international environment and thus compete against far more seasoned private equity managers. The journey so far has been impressive, and there is little reason to believe that it will not continue for the Norwegian private equity market as a whole.

The preferred jurisdiction and legal form for funds depends on several factors, inter alia, whether the fund will be marketed to international or Norwegian investors, the size of the fund, the size and professionalism of the fund manager and, not least, whether the fund will be operating in the venture or buyout market. All these factors are normally taken into account when private equity managers consider where to establish a fund. As the below will show, some clear distinctions can be made, though, and larger private equity houses may in reality be left with few other options than establishing a fund abroad.
Unlike many other European and offshore jurisdictions, Norway has yet to adopt fund legislation that is customised to cater to the needs of the private equity industry and investors in private equity funds. Norwegian private equity funds have to be established by using one of the ordinary commercial company structures, none of which have been developed specifically for the fund industry in general or private equity funds in particular. Seen with the eyes of international investors or the largest and most professional Norwegian private equity fund managers, the surrounding Norwegian infrastructure and back-office service providers are also less sophisticated and experienced than in many prominent European fund jurisdictions. Unfortunately, this implies that Norway is not a jurisdiction of choice for fund formation for the largest and most professional Norwegian private equity houses.

Currently the Norwegian private equity market can be split into three different levels. The lower level consists of private equity managers who have established their funds in Norway and who exclusively target Norwegian investors. Many of these are smaller players who do not meet a requirement from their targeted investors to establish the fund in an internationally acknowledged fund jurisdiction. Further, their assets under management and administrative resources often do not justify establishing a fund abroad. Indeed, establishing the fund outside Norway could be a competitive disadvantage for many of these players when compared with other private equity managers operating in the same level and segment.

The middle level consists of private equity managers who have established their funds in Norway and who only target international investors to a small degree in addition to Norwegian and Nordic investors, but who at the same time have an ambition to gradually expand their investor base to include more and larger international investors.

The upper level of the market consists of a relatively few larger Norwegian private equity managers who have established their funds outside Norway and who target an international investor base. At this level, fund formation within Norway has not been a realistic option for many years, as a great number of their targeted investors require fund formation to take place in an internationally acknowledged fund jurisdiction. Most of these private equity houses have set up their funds on Guernsey or Jersey. Most, if not all, funds have been established as limited partnerships under local law. The majority of these are buyout funds.

In principle, private equity funds can be established in Norway using any of the local commercial company structures. That said, Norwegian private equity funds are normally structured as limited liability companies (AS), internal companies (IS) or limited partnerships (KS). Limited liability companies are taxed as such and are not tax transparent. Partly for this reason, but also for, inter alia, increased capital flexibility, many investors and fund managers prefer to set up or invest in a tax-transparent vehicle, such as an internal company or limited partnership. For the past seven years or so, internal companies rather than limited partnerships have been the tax-transparent structure of choice for many Norwegian private equity houses.

In 2013, the Parliament amended the Limited Liability Companies Act and the Public Limited Liability Companies Act. The changes implied a significant simplification of the rules on the company capital, incorporation of the company and organisational matters. The share premium (i.e., paid-in equity in excess of the nominal amount of the share capital) was no longer restricted equity, but now forms part of the company’s distributable reserves. Further, the rules on calculation of distributable reserves were amended. The booked value of R&D, acquired goodwill and net deferred tax assets shall no longer be excluded in the basis for calculation of distributable reserves, thus generally increasing the dividend capacity.
While there previously were material restrictions on a limited liability company's ability to grant credit to, or provide security in favour of, foreign parent or sister companies, the new rules permit such credit and security, provided that the credit or security in question shall serve the economic interests of the group. It will suffice that one or more, and not necessarily all, companies in the group benefit from the credit or security.

Further, the previous strict prohibitions on a limited liability company granting credit or providing security in connection with a third party acquiring shares in the company itself or its parent company were modified. For private limited liability companies there will also no longer be a limitation as to how large a portion of the company’s shares the company may acquire as treasury shares (except that the company’s share capital less the nominal amount of the treasury shares must not fall below the minimum requirement for share capital). Public limited liability companies (ASAs) may still not hold treasury shares with a nominal value exceeding 10 per cent of the company’s share capital.

Whereas not all of the above changes are directly relevant for private equity funds, it remains to be seen if the simplifications will increase the popularity of limited liability companies as a company structure for Norwegian-domiciled private equity funds.

**ii Key legal terms and negotiable terms**

As noted above, fund formation of a closed-ended fund in Norway will have to be made using any one of the ordinary commercial company structures. Norwegian legislation does not contemplate the concept of specific company structures for private equity funds; nor is Norwegian legislation familiar with an overlying investment vehicle structure where one can choose between several different company structures for the establishment of the fund, such as the Luxembourg SOPARFI or SIF legislation.

As none of the Norwegian company structures have been developed for investment vehicle purposes, the applicable company legislation for the fund in question does not contain key legal terms that are more often found in other European fund jurisdictions. As an example, the company legislation for the most frequently used company structures does not set out minimum risk-diversification requirements or contain requirements for eligible assets, or other similar terms. Such terms are traditionally drafted in the fund’s constitutional documents, the governing partnership agreement and frequently also in side letters with the investors.

The types of negotiable terms vary to some extent, depending on the type of the fund in question. The most common negotiable terms include:

- management or advisory fees;
- key man provisions;
- requirements of co-investments from key men;
- whether the fund manager shall be permitted to establish new funds within the lifetime of the fund in question (and if so, when);
- the lifetime of the fund;
- whether a prolongation of the fund shall be permitted;
- removal of a manager on a fault or no-fault basis; and
- default provisions.
More recently, institutional investors have also increased their focus on corporate governance, transparency and social responsibility (SRI principles), including environmental issues and ethical investments. It is to be expected that SRI principles will be further developed in future years and that more investors will negotiate on SRI principles, as amended.

iii Disclosure and fiduciary duties
Norwegian private equity fund managers remained unregulated until the EU Alternative Investment Fund Managers Directive (AIFMD) was implemented in Norway (i.e., until 1 July 2014). As managers of closed-ended funds were unregulated in Norway for years, and as Norwegian legislation has no specific company structures for private equity funds, there are no specific key disclosure or fiduciary duties that are specifically aimed at or tailored to fit private equity fund managers, nor other managers of closed-ended funds. Hence, key disclosure requirements must be sought in ordinary prospectus rules (under the EU Prospectus Directive, as implemented), if applicable, and accounting law regarding requirements of publishing annual accounts and other reports, if applicable. Private equity funds are normally marketed under an applicable private placement exemption and prospectuses are thus rarely published. That being said, the same information will normally be provided in a PPM, although not necessarily on the same detailed level.

The fiduciary duty of the directors or the manager, if any, of a Norwegian private equity fund, when performing their duties for the said fund, follows from the minimum duty of care under the applicable company law. In many cases higher standards follow from an instruction for the board of directors, or another similar document.

iv Common methods of solicitation of investors and limitations on solicitation
Following the implementation of the Markets in Financial Instruments Directive (MiFID), marketing of financial instruments no longer qualified as an investment service in Norway under the Securities Trading Act. However, reception and transmission of orders and placing of issues of financial instruments qualify as investment services, and require a local licence or MiFID passport in Norway to provide such service to investors of a private equity fund or to the fund itself, respectively.

Funds established as internal companies or limited partnerships fall outside this regime and are subject to a somewhat softer regulatory regime. When MiFID was implemented into Norwegian law, the Ministry of Finance’s view was that interests in internal companies and limited partnerships fell outside the definition of ‘financial instruments’. This implied that ‘investment services’ rendered with respect to such interests fell outside the applicable licensing and prospectus requirements.

In order to increase investor protection for investments in such interests, a soft regulatory regime was introduced from 1 January 2013. Partnership or internal company interests were not included in the definition of ‘financial instruments’, however, which would have made all sales (excepting sole marketing) of such interests subject to the full scope of MiFID. Rather, MiFID investment services made with respect to such interests became subject to MiFID licensing requirements unless the investment services are only being provided to professional clients or eligible counterparties, or each client undertakes a minimum investment or

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subscription amount of 5 million kroner. For closed-ended funds incorporated as limited partnerships or internal companies, the aforementioned implied that until the AIFMD was implemented in Norway, non-MiFID licensed entities could market and sell (i.e., receive orders or place issues) interests in such funds under the above-mentioned exemptions without being locally licensed or MiFID passported. These rules changed significantly for funds qualifying as alternative investment funds (AIFs) when the AIFMD was implemented locally on 1 July 2014. From that date, marketing of closed-ended AIFs to Norwegian investors requires notification to, or pre-approval from, the Financial Supervisory Authority of Norway (FSAN), depending on the category of investors the AIF will be marketed to and the nationality of the AIF and the fund manager (AIFM) in question.

III REGULATORY DEVELOPMENTS

i Regulatory oversight for the funds, the fundraising process and the investors

As noted above, private equity managers and advisers were unregulated in Norway until H2 of 2014. Following the implementation of MiFID in 2007, Norwegian regulatory authorities concluded that the advisory activities of private equity houses fell outside the definition of providing ‘investment advice’ under MiFID, as implemented in Norway through the Securities Trading Act. Hence, neither funds nor their sponsors were approved nor registered by or with Norwegian regulatory authorities until the AIFMD was implemented in Norway in 2014. Larger fund sponsors that had established their funds abroad (typically Guernsey or Jersey) had been subject to foreign local requirements, as applicable, but fund sponsors as such had not been registered nor approved in Norway until 2014.

This changed when the AIFMD was implemented in Norway on 1 July 2014, through the AIF Act. How Norwegian private equity houses are affected by the AIF Act largely depends on how they have structured their businesses. The largest fund managers who have established their funds outside Norway and who target an international investor base have become fully regulated under the AIF Act as transposed into Norwegian law. Fund managers who, on the other hand, have established their funds in Norway and only target domestic investors, typically also fall below the AIFMD’s threshold. These managers have in general chosen to become registered with the FSAN, as opposed to being authorised under the AIF Act. AIFMs who also target non-professional investors must be authorised under the AIF Act in order to market their funds to this group of less sophisticated investors. In addition, active marketing of the fund cannot take place until the FSAN has permitted the fund for marketing in Norway, following an application from the fund manager regarding marketing of the fund. Private equity houses that have established their funds in Norway but that gradually want to market their funds to international investors will have to be authorised under the AIF Act to pursue their international ambitions.

While the AIFMD was transposed into Norwegian law on 1 July 2014, the European Venture Capital Fund regulation (EuVECA) and the European Social Entrepreneurship Fund regulation (EuSEF) (together, the Regulations) have yet to be implemented in Norway. Until the Regulations have been implemented into Norwegian law, the benefits of the Regulations are not available to managers intending to market their funds in the Norwegian market.

The Regulations, which came into effect on 22 July 2013 across all EU Member States, introduced a harmonised set of rules for certain qualifying venture capital funds and social entrepreneurship funds. The Regulations further introduced a softer marketing regime for certain alternative investment fund managers (AIFMs), as such AIFMs may market
their qualifying venture capital funds and social entrepreneurship funds as EuVECA or EuSEF-compliant across the EU pursuant to a marketing passport, without having to opt in under the full AIMFD regulatory regime.

As Norway is a member of the EEA, the Regulations do not have direct effect in Norway, but must be transposed into Norwegian law. Until that time, marketing in Norway of AIFs – be it venture capital funds, social entrepreneurship funds or other AIFs – must comply with the current Norwegian AIF marketing regime. In April 2015, the FSAN published a consultation paper proposing to implement EuVECA (Regulation (EU) No. 345/2013) and EuSEF (Regulation (EU) No. 346/2013) into Norwegian law. The deadline for submitting comments on the consultation paper expired in July 2015, and no comments advising against implementation were submitted. At the time of writing it seems somewhat uncertain if the Regulations will be transposed during 2017, although implementation on or around 1 July 2017 might take place.

ii Taxation of private equity funds resident in Norway

As described above, private equity funds established in Norway are normally structured as limited liability companies, internal companies or limited partnerships. A limited liability company is taxed as such, and according to the rules that apply for such companies.

A private equity fund will typically invest in shares in limited liability companies. The income in a fund is therefore made up of dividends and capital gains or losses. Hence, tax issues are related mainly to how dividends and capital gains or losses are taxed in the fund. Our description below is based on the assumption that the fund invest in shares.

Norwegian funds organised as limited liability companies are, through the exemption method, exempt from tax on dividends and on capital gains received on shares from Norwegian limited liability companies, although 3 per cent of the dividend must be entered as general income and taxed at the ordinary tax rate of 24 per cent. Losses upon the realisation of shares and costs incurred in connection with the purchase and realisation of such shares are equally not deductible for tax purposes.

The same exemption method applies for income that the funds may have from investments in limited liability companies and similar entities resident within the EU and EEA areas, provided of course that these companies are not artificial setups. For income from investments outside the EU and the EEA, the exemption method applies if the investment has been done in a limited liability company or similar entity, the shares have been owned for at least two years, and the fund owns at least 10 per cent of the shares and the corresponding votes in the company. The exemption method does not apply for investments in low-tax countries.

Partnerships resident in Norway are as a general rule transparent for Norwegian tax purposes. Thus, if the funds are organised as partnerships, taxation occurs at partner level and each partner is being taxed on a current basis for its proportional share of the net income generated by the partnership, regardless of whether such income is being distributed to the partners. However, dividends or capital gains received by the partnership from investments in limited liability companies or similar entities in Norway, or within the EU and EEA areas, are not taxed on a current basis.

iii Taxation of investors in Norwegian private equity funds investing in shares

The description below is based on the assumption that the private equity fund invest in shares in limited liability companies and similar.
**Investors resident in Norway**

Dividends distributed from Norwegian limited liability companies to Norwegian individual shareholders are taxable as general income at a rate of 29.76 per cent to the extent the dividends exceed a calculated tax-free allowance. The allowance is calculated on a share-by-share basis, and is equal to the cost price of the share multiplied by a determined risk-free interest rate based on the arithmetic average rate after tax of interest on treasury bills with three months’ maturity. The allowance will be calculated every income year. Any part of the calculated allowance one year exceeding the dividend distributed on the share the same year (unused allowance) is added to the cost price of the share and included in the basis for calculating the allowance the following year, and may also be carried forward and set off against future dividends received on the same share.

Sales, redemptions or other disposals of shares are considered as a realisation for Norwegian tax purposes. A capital gain or loss generated by a Norwegian individual shareholder through a disposal of shares are taxable or tax deductible in Norway. Such capital gain or loss is included in or deducted from the basis for computation of general income in the year of disposal. The general income is taxable at a rate of 29.76 per cent. The gain is subject to tax and the loss is tax deductible irrespective of the duration of the ownership and the number of shares disposed of. The taxable gain and deductible loss on the realisation of shares is calculated per share as the difference between the consideration received and the cost price of the share, and costs incurred in relation to the acquisition or realisation of the share. Any unused allowance on a share (see above regarding taxation on dividends) may be set off against capital gains related to the realisation of the same share, but this may not lead to or increase a deductible loss (i.e., any unused allowance exceeding the capital gain upon the realisation of a share will be annulled).

For partners in partnerships who are Norwegian individual shareholders, taxation occurs when the dividends or capital gains received are distributed from the partnership to such partners. Such distributions will be taxed as general income at a rate of 29.76 per cent. The Norwegian individual shareholders will be entitled to deduct a calculated allowance when calculating their taxable income; compare with the description of tax issues related to individual shareholders above.

Norwegian corporate shareholders (i.e., limited liability companies and similar entities) are exempt from tax on dividends received on shares in Norwegian limited liability companies and similar entities. However, 3 per cent of the dividends shall be entered as general income and taxed at the ordinary tax rate. Norwegian corporate investors are also exempt from tax on capital gains upon the realisation of shares in Norwegian limited liability companies and similar entities. Losses upon the realisation of shares and costs incurred in connection with the purchase and realisation of such shares are equally not deductible for tax purposes.

Norwegian corporate shareholders holding shares through a partnership will be exempt from taxation on their proportional part of dividends received and distributed by the partnership, although 3 per cent of the dividends shall be entered as general income and taxed at the ordinary tax rate. Norwegian corporate investors are also exempt from tax on capital gains upon the realisation of shares in the partnership. Losses upon the realisation of shares in the partnership and costs incurred in connection with the purchase and realisation of such shares are equally not deductible for tax purposes.
Investors resident outside Norway

Dividends paid by Norwegian limited liability companies to foreign shareholders, both corporate and personal shareholders, are as a general rule subject to withholding tax in Norway at a rate of 25 per cent, unless otherwise provided for in an applicable income tax treaty with Norway, or the recipient is covered by the specific regulations for shareholders resident within the EEA (see below). The withholding obligation lies with the company distributing the dividends.

Foreign individual shareholders who are resident within the EEA for tax purposes are subject to Norwegian withholding tax on dividends received from Norwegian companies at the regular rate or at a reduced rate determined in an applicable tax treaty. Such shareholders may, however, be entitled to a refund of an amount corresponding to the calculated tax-free allowance on each individual share (see above), based on a specific calculation for each case. Any unused allowance may be carried forward and set off against future dividends received on the same share.

Foreign corporate shareholders that are tax resident within the EEA are exempt from Norwegian withholding tax on dividends distributed from Norwegian limited liability companies and similar entities, provided that the shareholder is the beneficial owner of the dividends.

The taxation rules with regards to foreign partners in Norwegian partnerships are somewhat complicated, and not suitable for a detailed description in this article. However, in short, a foreign partner that receives dividend from the partnership will be regarded as conducting business in Norway, and thus taxable in Norway for that income at the regular tax rate for such income.

Capital gains on the realisation of shares in Norwegian companies owned by a foreign individual shareholder will not be subject to taxation in Norway unless the personal investor holds the shares in connection with the conduct of business activities in Norway, or has been a tax resident of Norway within the five calendar years preceding the year of the sale or disposition.

As a general rule, capital gains on the realisation of shares in Norwegian companies by foreign corporate shareholders are not subject to taxation in Norway. However, if a foreign investor is carrying on business activities in Norway and the shares are regarded as connected with such business activities (permanent establishment in Norway), the foreign investor may be subject to the same capital gains taxation as Norwegian investors, as described above.

IV OUTLOOK

On the market side, it seems that the steep fall for Norwegian oil-related industries have bottomed out and that the recovery has begun. Market conditions will probably remain difficult for many market players for a few more years, particularly within offshore supply, but Oslo Børs’ main index (OSEBX) have performed quite well since June 2016 and reached its all-time high on 26 January 2017 at 709.46 points. In fact, OSEBX climbed consecutively for the seventh month in a row in January 2017, and the turnover has not been higher since March 2016. Increased prices on important commodities such as oil, salmon and aluminium have helped push the OSEBX higher and have also fuelled the investors’ appetites for shares. At the time of writing the bond market has also made a remarkable recovery, and January 2017 saw records in both numbers of new bonds being listed at Oslo Børs, the total capital raised and the aggregate value of all bonds listed at Oslo Børs.
On the regulatory side, the continued growth and increase of professionalism in many private equity firms is likely to continue, and it is probable that the Norwegian market for private equity will become more international than it is today. Even though Norway's private equity industry has increased significantly since the early 2000s, the private equity market remains small, in relative terms. Hence, the Norwegian private equity industry largely depends on international capital to sustain continued growth, and several more private equity managers will be looking outside Norway for investors and investments. In line with this, we expect that international investors increasingly will be looking to Norway to put their money to work, in buyout funds as well as in venture, perhaps somewhat variably depending on the industry sector. We also expect more activity on the investment side, particularly in venture capital. Many incubators connected to universities and various research institutions are doing a lot of interesting work, which will in turn lead to a larger deal flow of investment grade companies. The main challenges for increased deal flow in the venture segment lies in capital access at the seed or pre-seed stage. The government has, however, strongly signalled that it will provide much more financial support than previously. Therefore, there is reason to believe that capital access will improve in the early stages, including by the use of various tax incentives.
Chapter 14

POLAND

Marcin Olechowski, Wojciech Iwański and Mateusz Blocher

I GENERAL OVERVIEW

Poland is consistently one of the most desirable destinations for private equity funds investing in central and eastern Europe (CEE). The country has experienced sustained and rapid growth since the 1990s when the market economy was reinstated. As the largest and most populous country in the region, Poland is a regional leader in economic terms with robust GDP growth. In 2015 GDP growth in CEE amounted to 3.1 per cent (nearly double that of the eurozone, i.e., 1.6 per cent), while in Poland at the same time it reached level of 3.6 per cent. CEE countries continue to be Europe's strongest region for GDP growth, with the estimated growth of 2.9 per cent for third quarter of 2016. Focus Economics Consensus Forecast's panellists projects for the Polish economy growth of 3.2 per cent in 2017.

In 2015, the value of private equity investments in Poland exceeded €800 million, which in terms of value constituted more than half of all private equity investments in the CEE region. Technology, media and communications comprises 21 per cent of all companies in Poland that are currently in the portfolio of private equity funds (excluding venture capital). A similar share belongs to companies from the industrial manufacturing sector (18 per cent), with the third position held by retail and consumer goods companies (14 per cent).

In 2015, CEE private equity investment measured as a percentage of GDP was 0.13 per cent on average for the region and remained below the European average of 0.3 per cent. The value of Polish private equity investments in relations to GDP amounted to 0.21 per cent, in 2015, before Italy (0.16 per cent) and close to Switzerland (0.22 per cent) or Germany (0.22 per cent). Importantly, no other CEE country had reached a higher position.

Buyout investments accounted in 2015 for most of the private equity investment value growth in CEE, amounting to €1.3 billion, which constituted an increase by 36 per cent year on year.

1 Marcin Olechowski is a partner, Wojciech Iwański is a senior associate and Mateusz Blocher is an associate at Soltysiński Kawecki & Szeląg.
3 Deloitte, Central Europe Private Equity Confidence Survey, October 2016.
4 Focus Economics, Poland Economic Outlook, 29 November 2016.
7 Ibid.
8 Ibid.
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 in the form of UCITS and non-UCITS type investment funds. The establishment and operation of such funds and of their managers are regulated under 2004 Act on Investment Funds and on Management of Alternative Investment Funds (IFA).

Moreover, since 4 June 2016, when the 2016 Act Amending the Act on Investment Funds and Certain Other Acts entered into force, there is an established legal framework for the new category of investment vehicles – namely alternative investment companies (ASI) – that are deemed as alternative investment funds (AIF) under AIFMD.9 ASIs are generally non-regulated investment vehicles, in the form of ‘ordinary’ commercial companies, governed by the applicable rules of the Commercial Companies Code.

A current trend remains the use of Polish investment funds as shareholders in a tax-transparent Luxembourg special limited partnership (SCSp) issuing interests qualified as transferable securities.

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

Polish law provides for two types of non-UCITS investment funds: FIZ and SFIO, both managed by an external and regulated investment fund management company (TFI). Such funds are of a specific legal nature that cannot be unambiguously qualified from the perspective of usual EU investment fund classifications (corporate, contractual or trust types of funds). Like corporate entities, Polish investment funds have a separate legal personality and governing bodies. On the other hand, they are strictly distinguished from typical commercial companies.

The IFA allows both an FIZ and an SFIO (provided it applies the principles and investment limits of an FIZ) to be established specifically as a ‘non-public assets fund’ 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 such 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 (NPA funds). 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 Commission (KNF) – which has publicly acknowledged that strict supervision of FIZs is not necessary, 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 forth 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 estates.

The IFA expressly states that in respect of foreign instruments, the qualification as ‘securities’ should be made 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, like the Luxembourg SCSp).

Type of investment certificates
FIZs may issue publicly and non-publicly traded investment certificates qualified as transferable securities under Directive 2004/39/EC on markets in financial instruments (MiFID). 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, as well as in registered or bearer form. In most cases, private equity investors choose non-publicly traded, dematerialised and registered investment certificates, which gives them expected flexibility and allows the avoidance of additional regulatory duties.

Diversification of investments
In order 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 from its registration subject to possible sanctions imposed upon the TFI by the KNF.
In the case of an FIZ operating as a private equity fund, such period is extended to three years. Based on certain further exceptions related to FIZs established for a specified time, Polish TFIs are in a position to prolong the transition period up to six years (or even rolled constantly).

**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 due to the fact that 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 this scope, the members of the board of investors 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, reserved for FIZs operating as NPA funds and resulting from the direct sale of an FIZ’s assets. Rules of redemption of certificates 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 an 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) that 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, such 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

Recent changes in Polish law

Recent implementation of AIFMD into the Polish law significantly affected the use of commercial companies as investment vehicles. Such companies are now classified as alternative investment companies (ASIs) and subjected 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 might not 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 capitals. 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 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 as of today include the following legal forms:

<table>
<thead>
<tr>
<th>Externally managed</th>
<th>FIZs</th>
<th>SFIOs</th>
<th>SKA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internally managed</td>
<td>–</td>
<td>–</td>
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</tbody>
</table>

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. Investors should consequently 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 certainly should consider the partnership’s deed in that scope.

**Partnership limited by shares (SKA)**

An SKA structure combines the elements of a limited partnership and 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). An SKA being an ASI 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. In order 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 (Sp. z o. o.)

An 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. An ASI and the earlier described regulatory framework applicable to limited partnerships and SKAs. Unlike in the latter cases, an ASI being a limited liability company is its own ZASI and cannot engage in 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 (SA)

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) need to 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) need to 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) constitutes regulated services and is restricted for investment firms. The applicable distribution rules and the scope of mandatory disclosure are in that case subject to Poland’s local implementation of 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 such an activity without the required permit could be subject to criminal responsibility. If a criminal investigation is triggered by the actions of the KNF, the suspected entity is immediately disclosed on the KNF website.

Distribution of units in SFIOs is subject to the special regulation 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 qualify 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 the Polish consumer protection laws, 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, such TFI would be subject to quite restrictive regulatory sanctions imposed by the KNF.

Recent 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 to 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 recent 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:

a adoption of the FIZ’s statutes by the TFI;
b execution of an agreement with a depositary on the maintenance of a register of the fund’s assets;
c the KNF’s authorisation for the establishment of an FIZ (with the reservation outlined below);
d collection of payments in the amount stipulated in the fund’s statutes (in the case of publicly traded certificates, not less than €40,000); and
e entry in the register of investment funds.

The investment fund acquires legal personality upon its registration in the register of investment funds, which is maintained by the District Court of Warsaw. Upon registration, the management company becomes the governing body of the investment fund.

Establishment of an FIZ whose investment certificates are not publicly traded 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 supervise 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 commercial companies being classified as ASIs trigger some regulatory duties differentiated according to the value of the investment portfolio.

**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) or interest payable by such 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 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 respective double tax treaties and internal regulations).

**IV OUTLOOK**

The current number one topic of discussion in the Polish private equity market is the actual shape of the market after the implementation of AIFMD and UCITS V directives and the expiry of the adjustment period. It is rather unquestioned that the above changes in the regulatory regime would put an end to the ‘explosion’ of FIZs in the Polish market started with the deregulation of 2011. The changes in question would, in turn, give rise to new trends within the currently existing financial structures involving FIZs. The recent legislative efforts introduced a new institutional framework fostering greater transparency and better investor protection for investors committing their funds to such investment vehicles. As of now, the future role of ASIs in the Polish private equity market is unclear. What is equally unknown is the influence of the above changes to the taxation of FIZs on the development of the private equity market.
I GENERAL OVERVIEW

i Introduction

Since 2009, there has been a gradual trend towards financial deleveraging of Portuguese companies, and less financing provided by Portuguese banks. The average indebtedness of Portuguese companies went from €4.121 million at the end of 2009 to €3.564 million at the end of 2015, for medium enterprises, and from €17.282 million at the end of 2009 to €11.955 million at the end of 2015, for large enterprises. Furthermore, in 2012, approximately €234 billion and €79 billion was provided to Portuguese companies in the form of loans and current account facilities, respectively; and in 2015 these figures were only approximately €208 billion and €56 billion for each type of product, respectively (figures for the entire 2016 were not available at the time of writing but also indicate a downward trend, with the amounts for the first three quarters combined being approximately €155 billion for loans and €38 thousand million for current account facilities).

In this context, private equity is an important alternative source of capital for Portuguese businesses.

ii Recent fundraising figures and trends

The most recent reports on private equity activity, both from industry sources and from Portuguese official sources contain information up until the end of 2015.

Fundraising activity in Portugal decreased significantly in 2015, when compared to 2014. According to Invest Europe, a total of €35.83 million was raised in Portugal in 2015, which compares unfavourably with the €96.82 million raised in 2014. This amount comprises the lowest amount of funds raised by private equity funds in Portugal since 2007 (except in 2008, when only €15.22 million was raised).
The amount raised during 2015 is exclusively attributable to independent funds. In other words, there was no fundraising activity by captive or non-independent funds in Portugal in 2015. In comparison, the amount raised by captive or non-independent funds in 2014 was €86.7 million, amounting to 89.5 per cent of the total funds raised in that year, and the amount raised by independent funds was €10.12 million, or 10.5 per cent of the total funds raised. It is worth noting that, although the total amount of funds raised in 2015 only comprised just over a third of the funds raised in 2014, the amount raised by independent firms more than tripled from one year to the other.

As to the profile of funds that have raised amounts in 2015, statistics show that the ‘generalist’ private equity funds have been predominant, having raised €32.3 million, or 90.1 per cent of the total funds raised. The rest of the funds raised in 2015 derive almost exclusively from a single venture capital fund with a focus on early-stage investments, which accounts for €3.3 million, or 9.2 per cent, of the total funds raised. In terms of the number of players that have been active in fundraising, said sum of €32.3 million raised by ‘generalist’ funds is attributable to only two funds, while the €3.3 million also referred to was raised, as mentioned, by a single venture capital fund. With a residual amount having been raised by a fourth fund, the total number of active funds with regard to fundraising in 2015 is four, which is the same number of funds that participated in fundraising activities in 2014 (the number of funds active in fundraising having peaked in 2011, with 15 funds).

As regards incorporation or beginning of activity of new funds, according to the Portuguese Securities Market Commission’s (CMVM) website, a total of 17 and 10 funds were incorporated in 2015 and 2016, respectively.

According to the CMVM’s 2015 annual report on the Portuguese private equity sector, at the end of 2015, the size of the Portuguese private equity industry (defined as the sum of (1) equity holdings, (2) loans and other forms of equity or debt financing claims, (3) equity options held by funds incorporated in Portugal and (4) capital commitments from investors that are not yet paid up) was €4.5 billion. Out of this amount, 19.4 per cent (i.e., €873 million) corresponded to not yet paid-up capital commitments from fund investors.

iii Time required to raise funds
The time required to raise funds depends on several factors, particularly the complexity and length of the negotiation of the underlying documents with investors and other parties. In our experience, a fundraising process could take between six months to one year to complete. In any case, the actual duration of the process depends on the specific circumstances of the case at hand.

II LEGAL FRAMEWORK FOR FUNDRAISING
i Overview
The main statutory instrument governing private equity in Portugal is Law No. 18/2015, of 4 March (the PE Legal Framework), which transposes Directive No. 2011/61/EU of the

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10 ‘Funds’ in this case referring to any type of private equity investor that is incorporated in Portugal, regardless of the specific legal entity form that is adopted.
11 See footnote 7.
European Parliament and of the Council of 8 June on alternative investment fund managers (AIFMD) into Portuguese law. The PE Legal Framework repealed Decree-Law No. 375/2007, of 8 November, which previously governed private equity in Portugal.

The PE Legal Framework regulates, notably, the following matters: (1) what is considered a private equity investment under Portuguese law; (2) the legal forms that can be adopted by funds and fund management entities incorporated in Portugal; (3) the registration and prior authorisation requirements that funds and fund management entities must meet, (4) which operations may be carried out by private equity funds and managing entities and which operations are prohibited, (5) the minimum capital requirements that private equity funds and managing entities must meet, (6) the obligations in relation to reporting of annual accounts, (7) governance matters, (8) dissolution, liquidation, merger and demerger of unincorporated funds, (9) for funds and managing entities that exceed the thresholds set out under the AIFMD, the duties and requirements that such funds and managing entities must comply with (as indicated below), and (10) the sanctions that the CMVM can impose and the scope of its supervisory and regulatory powers.

The PE Legal Framework defines private equity investing as ‘the acquisition, for a limited period of time, of equity instruments or debt instruments in companies with a high growth potential, as a way to benefit from the improved valuation of such companies’.12

CMVM Regulation No. 3/2015 on private equity, social entrepreneurialism and alternative investment fund management (Regulation 3/2015) governs some matters foreseen in the PE Legal Framework in more detail.

ii Preferred jurisdictions for funds

Portugal is generally the jurisdiction of choice for Portuguese sponsors to incorporate funds or vehicles used by funds to conduct their investments. However, some Portuguese sponsors have used structures (especially to invest in non-performing loans) that include entities incorporated outside Portugal, particularly in Luxembourg. Foreign sponsors may use Portuguese vehicles to invest in Portugal but generally also use structures involving foreign entities, with Luxembourg, again, being a prevalent choice. In both cases, the choice of jurisdiction is usually influenced by tax structuring concerns.

iii Legal forms

The following are the main legal forms foreseen under the PE Legal Framework for Portuguese entities that aim to conduct private equity investment (as defined thereunder):

a private equity companies (SCRs);
b private equity unincorporated funds (FCRs);
c private equity investors (ICRs);
d private equity fund management companies’ (fund management companies); and
e private equity investment companies (PE investment companies).

The PE Legal Framework draws an important distinction between (1) entities that are not allowed to exceed certain assets under management thresholds set out under the AIFMD (SCRs, FCRs managed by SCRs and ICRs), and (2) entities that are allowed to exceed them (fund management companies, FCRs managed by fund managing companies and PE

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12 Article 3 of the PE Legal Framework.
investment companies). The former entities are subject to a less demanding regulatory regime under the PE Legal Framework; the latter are subject to stricter rules that were established in the PE Legal Framework so as to ensure that Portuguese law complies with the requirements of the AIFMD.

**SCRs, FCRs and ICRs**

As mentioned above, SCRs, FCRs – if managed by SCRs – and ICRs are subject to less demanding regulatory requirements under the PE Legal Framework. In addition, they must not exceed certain thresholds set out under the AIFMD. Specifically, SCRs, FCRs that are managed by SCRs and ICRs must not (1) exceed €100 million of assets under management, when any such assets were acquired by using leverage, or (2) exceed €500 million of assets under management, when all assets are unleveraged, and have no redemption rights exercisable against them by investors during a period of five years following the initial investment.

SCRs have legal personality and must be incorporated as private limited liability companies by shares, with a minimum share capital of €125,000, mandatorily represented by nominative shares. As SCRs adopt a corporate form, they are subject to the general rules of the Portuguese Companies Code, in all matters that are not specifically regulated under the PE Legal Framework. The main constitutional documents of an SCR are its articles of association and internal regulations. An SCR that adopts the Latin Governance Model (the most common governance structure among Portuguese companies) is governed by a board of directors and supervised by a supervisory board plus an external auditor that must be registered with the CMVM. Subject to certain limitations established by law, special classes of shares may be issued by SCRs, notably preferred shares. SCRs can engage in private equity investing directly and act as managing entities of FCRs. SCRs (and, generally, FCRs and ICRs) are forbidden from engaging in certain types of transactions, notably, investing in real estate (but they can acquire real estate to set up their offices).

FCRs are unincorporated entities that have no legal personality (although they can be a party to judicial proceedings as a claimant or defendant). An FCR is not liable for the debts of its investors; similarly, FCRs have limited liability, i.e., investors are not liable, as a general rule, for an FCR’s debts. Ownership of an interest in an FCR is represented by participation units, which are considered securities under the Portuguese Securities Code. FCRs must be managed by a managing entity, which may be, in particular, an SCR or a fund management company; decisions on structural matters, however, require the approval of a general meeting of fund participants. The main constitutional document of an FCR is its management regulations. An FCR must have a minimum subscribed capital of €1 million. The minimum capital subscription that can be made by an FCR investor is of €50,000, except for members of the managing entity’s management board (who can subscribe lower amounts). Different classes of participation units may be created, bestowing different rights upon their respective holders, provided that the existing classes of participation units are foreseen in the managing regulations and are ‘consistent with the risk profile and investment policies’ of the FCR.13

ICRs have legal personality and must be incorporated as sole shareholder private limited liability companies by quotas. The sole shareholder of ICRs must be a natural person.

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13 Article 23 of the PE Legal Framework.
**Fund management companies, FCRs managed by fund management and PE investment companies**

As mentioned above, fund management companies, FCRs managed by fund management companies and PE investment companies may exceed the assets under management thresholds foreseen under the AIFMD. However, they are also subject to stricter regulatory requirements pursuant to the PE Legal Framework (which seeks, in this regard, to implement the requirements of the AIFMD).

Fund management companies must be incorporated as private limited liability companies by shares with a minimum share capital of €125,000, mandatorily represented by nominative shares. Their main corporate purpose is the management of FCRs or of PE investment companies. They are also allowed, particularly, to act as managing entities of ‘undertakings for specialised alternative investment’.

PE investment companies must likewise be incorporated as private limited liability companies by shares. These entities may be internally managed or externally managed (particularly by fund management companies). If they are internally managed, they must have a minimum share capital of €300,000, also mandatorily represented by nominative shares. Their purpose is to make private equity investments (as defined in the PE Legal Framework).

The PE Legal Framework regulates the following matters in relation to fund management companies and PE investment companies:

- **a** authorisation requirements;
- **b** suitability of members of corporate bodies with management roles and of shareholders holding equity stakes above specific thresholds;
- **c** remuneration policies;
- **d** prevention of conflicts of interest;
- **e** risk management;
- **f** internal organisation requirements;
- **g** delegation of functions;
- **h** liquidity management;
- **i** asset valuation; and
- **j** reporting requirements, among others.

Fund management companies and PE investment companies are authorised to exercise their activities (including marketing funds) in other European Union Member States, subject to the rules set out under the AIFMD, as transposed into the domestic law of each Member State.

**Preferred legal forms**

As per the information available on the CMVM’s website, FCRs are by far the predominant legal form out of the legal forms foreseen under the PE Legal Framework. A total of 87 FCRs are registered with the CMVM, compared to 43 SCRs and one fund management company.

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iv Key negotiable terms

Fundraising transactions usually entail the negotiation between sponsors and fund investors of the constitutional documents of the fund (management regulations in the case of FCRs or articles of association and internal regulations in the case of SCRs), as well as of ancillary documents (which vary on a case-by-case basis, e.g., investment agreements, side letters).

Terms that are usually carefully negotiated between sponsors and investors include:

- fund indebtedness limitations;
- investment policies;
- distribution policies;
- rules regarding the removal of the managing entity (in the case of funds that are externally managed);
- investor rights, including economic, voting and information rights;
- the duration of the fund until liquidation;
- the duration and amount of capital commitments and procedure for making cash calls;
- sponsor remuneration (which usually includes management fees charged as a percentage of committed capital as well as carried interest provisions);
- the functioning of general shareholders’ meetings or fund participants’ meetings (including number of ordinary meetings required per year, procedures for summoning meetings, quorum requirements, etc.);
- limitations regarding transfer of interests in the fund;
- ‘key person’ provisions (which may include the suspension of all investment or divestment activities in the absence of a designated ‘key person’, cuts to the remuneration due to the managing entity and the option for investors to decide on the liquidation of the fund); and
- the existence of ad hoc bodies, such as investment committees, as well as the composition, the powers, and the functioning of the same (in relation to the latter, it is understood that, in funds that are externally managed, committees comprised by investors may only have a consulting role, namely, they are not allowed to take binding decisions on investments or divestments, as such would collide with the functions bestowed by law upon the managing entity. Furthermore, there has been precedent of the CMVM arguing that provisions that determine that investors are eligible to sit on ad hoc committees exclusively on the basis of the amount of their commitment are not valid, as this arrangement can be deemed a breach of the generic principle set out in the PE Legal Framework pursuant to which managing entities must treat fund investors in equal terms).

v Key disclosure items

Pursuant to Regulation 3/2015 on private equity, social entrepreneurialism and alternative investment fund management, which seeks to govern some matters foreseen in the PE Legal Framework in more detail, SCRs and fund management companies are required to provide in a clear way and prior to an investment decision the following information to potential investors to which they are marketing interest in a fund: (1) the identity of the managing entity and of any service providers hired by the managing entity to render services relating
to the fund management; (2) the amount of funds available to the managing entity, and an explanation of why the managing entity deems such amount to be adequate to pay for the technical and human resources required to manage the fund appropriately; (3) a description of the investment strategy and objectives of the fund, indicating, notably, which characteristics must be met by eligible investment targets, which investment techniques the fund intends to implement and which investment restrictions apply; (4) a description of the fund’s risk profile and details of the risks inherent to the asset classes in which the fund intends to invest or inherent to the investment techniques to be used by the fund; (5) description of the valuation methodologies to be used by the fund when evaluating its assets; (6) a description of how the managing entity’s remuneration is to be calculated; (7) a description of all relevant costs to be incurred by the fund and the maximum amount of such costs, (8) historical data on the fund financial performance, (9) a description of the company support services and other support activities that may be rendered by the managing entity, directly or through third parties, with the purpose of facilitating the development or growth or any other aspects relating to the companies in which the fund is to invest, or, if no such services are rendered, an explanation on why that is the case; and (10) a description of the procedures that may be followed to change the fund’s investment policy or investment strategy, or both.

The managing regulations of FCRs, to which investors are deemed to adhere when acquiring or subscribing participation units must include the following information, among others: duration of the fund and conditions for a possible extension; capital amount; terms under which the fund can increase and reduce capital; description of the rights inherent to different classes of participation units; capital subscription and payment rules; investment policies; indebtedness limitations; distribution policies; asset valuation criteria; frequency with which information on the funds’ assets and the value of each participation unit is communicated to investors; information on remuneration payable to the managing entity; and terms and conditions applying to fund liquidation.

Similarly, disclosure requirements apply to the marketing of funds that are managed by entities that exceed the thresholds set out in the AIFMD.

Finally, it should be noted that, whenever the marketing of a fund involves a public offer, a prospectus must be prepared, with the minimum information requirements set out under Portuguese and European law, notably the Portuguese Securities Code and Regulation (EC) 809/2004 of 29 April.

vi Solicitation of investors

Solicitation by private offering is the predominant method of marketing private equity funds in Portugal and, to the best of the authors’ knowledge, no solicitation of investors by public offer has taken place in Portugal recently.

The incorporation of FCRs\(^{16}\) and the commencement of activity by ICRs that have not been marketed to the public and have only been marketed to ‘qualified investors’ (as defined under Portuguese law) or, alternatively, in which the minimum subscribed capital of each individual investor is at least €500,000 (whether or not investors are ‘qualified investors’), is subject only to a prior communication addressed to the CMVM, as opposed to requiring

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\(^{16}\) Other than FCRs that are managed by fund management companies, which are subject to the tighter regulatory framework applying to entities that exceed the AIFMD thresholds.
prior registration with the CMVM or prior authorisation by the CMVM. As such, sponsors may have an incentive to market funds allowing only minimum capital commitments of at least this amount, so as to benefit from this rule.

As mentioned above, the solicitation of investment from the public, if considered a public offer under the Portuguese Securities Code, requires the preparation of a prospectus as well as compliance with rules applying to public offers generally and public distribution offers particularly under Portuguese and European law. Pursuant to the Portuguese Securities Code, and as a general principle, an offering is considered as a public offer whenever it is addressed in whole or in part to undetermined recipients. Offers that are preceded or accompanied by prospection and collection of investment commitments, or preceded or accompanied by advertising under any form, as well as offers that are addressed to at least 150 'non-qualified' investors domiciled in Portugal are also considered public offers. Offers addressed exclusively to 'qualified investors' are always deemed private offers.

vii  Fiduciary duties of sponsors

Pursuant to the PE Legal Framework, as a general rule, entities that manage FCRs are required to exercise their activities in an independent way and in the exclusive interest of the investors, with a view to protecting their legitimate interests and ensuring fair and equal treatment for all of them. Managing entities must also refrain from participating in any dealings that may entail a conflict of interest with investors of funds managed by them. Furthermore, managing entities must have an organisational structure and internal procedures that are adequate, in proportion, to their dimension and the complexity of the activities carried out by them.

In addition, fund management companies and PE investment companies, have, among others, the following specific duties to: (1) defend not only the best interest of investors but also market integrity in general; (2) have the resources and processes required for the exercise of their activities, and use them in an efficient way; (3) take all reasonable measures to prevent conflicts of interest and, whenever such conflicts cannot be avoided, to identify, manage and follow-up on such conflicts and, if required, to communicate such conflicts of interest so as to avoid them having an adverse effect on the interests of the funds and their investors, as well as to ensure that the funds managed by them are treated on fair terms; (4) treat all fund investors fairly; (5) have a functional and hierarchical separation between risk management functions and operational functions; and (6) implement adequate liquidity management systems so as to have control over the liquidity risk of the funds managed by them.

III  REGULATORY DEVELOPMENTS

i  Regulatory oversight

The CMVM is the national authority appointed under the PE Legal Framework with supervisory responsibilities in relation to matters such as the incorporation and authorisation of private equity funds and managing entities in Portugal as well as the marketing of funds and, generally, fundraising for private equity funds in Portugal.

The CMVM is endowed with a broad range of prerogatives to enable it to conduct its supervisory role (including investigation powers). Such prerogatives are listed in the Portuguese Securities Code, with specificities being included in the PE Legal Framework.

The PE Legal Framework specifically endows CMVM with the power to issue regulations on a number of matters pertaining to the activity of private equity funds and managing entities, in particular, the evaluation of assets and liabilities, information duties,
authorisation and registration procedures, suitability requirements applicable to corporate body members and qualified shareholders, among others. Regulation 3/2015 governs some of these matters.

Pursuant to the PE Legal Framework, in exercising its supervisory role, CMVM shall take into consideration any guidance issued by the European Securities and Markets Authority.¹⁷

Some suitability requirements may apply to investors that hold interests in specific types of funds or managing entities in excess of certain thresholds, as per the PE Legal Framework.

**ii Fund or sponsor registration**

Private equity funds and managing entities incorporated in Portugal are in principle subject to either ‘registration’ with the CMVM or ‘prior authorisation’ by the CMVM. The registration requirements are less strict than those applicable to obtaining prior authorisation from the CMVM.

Registration applies to entities that do not exceed the thresholds set out under the AIFMD (i.e., SCRs, FCRs managed by SCRs and ICRs). However, and as mentioned above, registration can be replaced by a prior communication addressed to the CMVM in the case of FCRs that have only been marketed to ‘qualified investors’ or in which the minimum subscribed capital of each individual investor is at least €500,000.

Prior authorisation applies to entities that are allowed to exceed the thresholds set out under the AIFMD (i.e., fund management companies, FCRs managed by fund management companies, and PE investment companies).

**iii Taxation**

The worldwide income derived by FCRs set up and operating under Portuguese law is exempt from corporate income tax (CIT) in Portugal. As a result of the full CIT exemption, FCRs generally are not able to benefit from tax credits arising from foreign taxes charged on income derived abroad.

Income paid or made available by FCRs to Portuguese-resident corporate unitholders through the distribution of profits, redemption of units, or liquidation of the fund, is subject to a flat 10 per cent withholding tax with the nature of a payment on account of the final tax due. Capital gains obtained by Portuguese-resident corporate unitholders with the disposal of units is subject to CIT at the standard rate of 21 per cent, possibly added to a state surcharge, levied on taxable profits in excess of €1.5 million at a rate of up to 7 per cent, and a municipal surcharge also levied on taxable profits at rates of up to 1.5 per cent (depending on the municipality).

If the income is paid or made available to Portuguese-resident individuals, the flat 10 per cent rate also applies and the withholding is final, unless the individual elects to aggregate the income with the remaining income subject to personal income tax (PIT), in which case the general progressive PIT rates apply. In this case, the withholding tax paid has the nature of a payment on account of the final tax due and, provided that certain conditions are complied with, the individual will be entitled to deduct for PIT purposes 50 per cent of the income paid by the FCR corresponding to dividends distributed by the FCR. Capital gains obtained by resident individuals are subject to a special PIT rate of 10 per cent.

Income and capital gains derived by non-resident unitholders (either companies or individuals) are exempt from tax in Portugal, unless the investor is resident in a listed tax haven or, in case of companies, if the corporate unitholder is held in at least 25 per cent by a Portuguese-resident entity, in which case the 10 per cent rate applies.

SCRs are subject to the general Portuguese CIT regime. The worldwide income derived by SCRs is subject to CIT at the standard rate of 21 per cent, possibly added to a state surcharge, levied on taxable profits in excess of €1.5 million at a rate of up to 7 per cent, and a municipal surcharge also levied on taxable profits at rates of up to 1.5 per cent (depending on the municipality). However, SCRs are entitled to deduct from the CIT due the amount of the investments made in companies with growth and capitalisation potential. The deduction may be taken in the tax year in which the relevant investment is made or in the following five tax years, and is limited to the sum of the CIT due in the five tax years prior to the one in which the relevant investment is made. Moreover, dividends and capital gains obtained by SCRs may be exempt from CIT under the Portuguese participation exemption regime, provided certain conditions are met.

Income paid or made available by SCRs to Portuguese-resident companies should be subject to withholding tax at a 25 per cent rate with the nature of a payment on account of the final tax due, or exempt from withholding tax if the participation exemption regime applies. Capital gains derived by Portuguese-resident companies with the disposal of shares in SCRs may be exempt from CIT provided that the participation exemption regime applies.

If the income is paid or made available to Portuguese-resident individuals, a 28 per cent final withholding tax should apply, unless the individual elects to aggregate the income with the remaining income subject to PIT, in which case the general progressive PIT rates apply. In this case, the withholding tax paid has the nature of a payment on account of the final tax due and, provided that certain conditions are complied with, the individual will be entitled to deduct for PIT purposes 50 per cent of the income paid by the SCR corresponding to dividends distributed by the SCR. Capital gains derived by Portuguese-resident individuals with the disposal of shares in SCRs are subject to PIT at a special 28 per cent rate, and the individual may also opt to aggregate the gains with the remaining income subject to the general progressive PIT rates.

Income derived by non-resident companies should, as a general rule, be subject to withholding tax at a 25 per cent rate. However, a reduced withholding tax rate may apply under a double tax treaty entered into by Portugal, or the income may be exempt from withholding tax under the Portuguese outbound participation exemption regime.

Income derived by non-resident individuals should be subject to withholding tax at a 28 per cent rate or to a reduced withholding tax rate under an applicable double tax treaty.

Capital gains derived by non-resident companies or individuals are, as a general rule, exempt from tax in Portugal under a domestic exemption or an applicable double tax treaty.

iv Key changes to the regulatory and tax regime
There were no major changes to the Portuguese regulatory and tax regime applicable to private equity last year. The latest major pieces of legislation enacted were the PE Legal Framework, which was enacted in 2015, and which, as mentioned above, implements the AIFMD in Portugal, and Regulation 3/2015 on private equity, social entrepreneurialism and alternative investment fund management, which seeks to govern some matters foreseen in the PE Legal Framework in more detail.
IV OUTLOOK

No major legislative or regulatory changes concerning the private equity sector are expected in the near future in Portugal.

Buyouts, investments in mature companies or investment in non-performing loans have all historically predominated over venture capital, seed capital and, generally, investment in companies in earlier stages of development in Portugal. However, Lisbon is gaining increased international visibility as having a thriving start-up scene, as is exemplified by the city hosting the 2016 edition and in all probability the 2017 edition of the Web Summit.¹⁸

Although it remains to be seen if a start-up scene actually develops and manages to gain momentum in Lisbon, the venture capital industry could face parallel growth.

¹⁸ www.websummitlisbon.pt/homepage.
I GENERAL OVERVIEW

Saudi Arabia is widely considered to be a country flush with cash due to 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. While the stock market performed around 4 per cent higher in 2016 than in 2015, buoyed by a strong fourth quarter, 2015 was a historically poor year with market capitalisation dropping by nearly 20 per cent.

This 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 two years, and are reticent to invest in funds structures.

As such, other than blue-chip managers, many sponsors have found fundraising to be difficult in 2016. This difficulty is also exacerbated by the existence of a very few regional asset managers and private equity funds with considerable track records, which is a key factor in successful fundraising.

According to the 10th Annual MENA Private Equity and Venture Capital Report published by the MENA Private Equity Association in 2016, fundraising levels have declined due to 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 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 of Saudi Arabia towards the UAE, and to a larger extent to 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 the Kingdom (which has experienced a turbulent past year).

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 successfully secured the necessary capital within the one-year period and held the closing of the fund. Blind pool venture capital and private equity funds raising has taken substantially longer and required multiple closings. Most of these funds have not been able to raise the target funds during the one-year period, and as such, managers have had to seek an express exemption to offer beyond the statutory maximum period.

Fundraising in Saudi Arabia, as is the case elsewhere in the region, is challenging for many market participants due to 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 benefit of the deal-by-deal approach is that investors are more assured of the growth prospects and corporate governance of the underlying investment target, and are therefore 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 compete with other regional funds in terms of fundraising. Further, over the past several years, venture capital activity has dramatically increased in Saudi Arabia, and due to the small deal size, deal-by-deal investments are impractical and investors have participated in such blind-pool funds (although the average ticket size tends to be small).

While the current size of the private equity fundraising market is unclear, according to public CMA records, 10 private equity and venture capital funds were launched in 2016. Several managers, including Riyad Capital, Jadwa Investment Company, Wasatah Capital and Derayah Financial, successfully closed private equity and venture capital funds.
II LEGAL FRAMEWORK FOR FUNDRAISING

With just under 300 privately placed funds and a similar number of publicly offered funds in the Kingdom, Saudi Arabia is the most popular jurisdiction in the region for locally domiciled investment funds. Such success may be attributed to a number of reasons, including the competence of the CMA as the regulator of investment funds in Saudi Arabia.

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.

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 the fund manager or 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, and not the more restrictive MoCI, funds may provide investors with certain rights and obligations that are not otherwise available under the more typical investment vehicle structure of a limited liability company. Such provisions include capital commitment structures, default remedies, dilution, forced exits and redemptions.

The offering documents of a CMA private equity fund (which include the terms and conditions and private placement memorandum) follow a prescribed form that is set forth 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, 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

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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 allocation of units post-closing.

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 road show process after the lapse of the CMA’s 15-business-day review period. Such funds need to 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.

Certain requirements, such as satisfying a minimum investment amount requirement of 1 million Saudi riyals by the investor, must be satisfied in order the funds to be offered and sale to be consummated. Further, the foreign 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 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 such 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.
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 to 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).

In addition, and as a matter of practice, the CMA has increasingly scrutinised blind-pool investment funds and real estate development funds. Due to this heightened scrutiny and the relative ease with which managers can establish private CMA funds, there has been a significant shift toward single asset funds, particularly single asset real estate private equity funds with very limited numbers of investors.

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 GAZT has reserved the right to begin taxing funds at any point in the future (including on a retroactive basis).

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.

During 2016, the CMA issued a number of new regulations intending to encourage foreign investment in Saudi Arabia and to 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 which can be accessed by the Saudi public in order to encourage individuals to invest their income in the Saudi domestic market. As such, throughout 2016 the CMA 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.

In particular, the amendments to the funds regulations are pivotal for asset managers and sponsors seeking to raise funds from the Saudi market. After a consultation period, the new funds regulations were released in May 2016 and became effective on 6 November 2016. 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 fund regulations to provide clarity and to encourage more managers to launch funds. The CMA has intended to revamp the prior regulations in order to codify unwritten practices of the CMA, to address problems of investor protection that
arose during the financial downturn and to 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, the 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 if 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 more flexibility when it comes to structuring fund governance, but potentially removes a 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 invested targeted. It had been widely hoped that the new funds regulations would set out certain exemptions to the requirement to register funds with the CMA; however, no exemptions to registration with the CMA were provided for locally domiciled or foreign funds.

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

In Singapore, no official statistics are published by any organisation on the size of the private equity (PE) fundraising market.

The Monetary Authority of Singapore (MAS) publishes an annual survey of the fund management industry, and the 2015 survey reported that total assets managed by Singapore-based asset managers grew by 9 per cent to S$2.6 trillion, compared with an end-of-year total of S$2.4 trillion in 2014.

The 2015 survey also reported that funds employing ‘alternative investment strategies’ (which comprise PE, hedge funds and real estate), which accounts for about 29 per cent of the total assets under management (AUM), saw strong growth in 2015. As at end-2015, overall hedge fund AUM grew by 11 per cent to S$119 billion and overall PE fund AUM grew by 47 per cent to S$136 billion.

Based on anecdotal evidence, the number of Singapore-based fund managers who described themselves as PE fund managers and were in the fundraising stage might be as high as 35 to 50. Certainly, managers seeking money to invest in real estate in mature and emerging Asian markets or seeking to invest in the growth of companies in the emerging market economies of Indonesia, Indo-China and South East Asia predominate on the fundraising scene. Typically, a real estate-focused PE fund may seek to raise between US$100 million and US$500 million, while a growth-investing PE fund may close a fund after raising as little as US$25 million up to a ballpark amount of US$200 million.

The reception given by potential limited partners (LPs) to fundraising by Singapore-based general partners (GPs) is no different from that seen elsewhere in the world. Fund managers with a successful track record of investing and delivering value are rewarded with ‘re-ups’ by existing LPs, and could secure new LPs. Generally, they could raise a subsequent fund larger than their immediately preceding fund. The market in Singapore is marked by more first-time fund managers raising their maiden funds than would be the case in more mature markets. A first-time fund manager would usually see a seasoned PE professional who has left an established brand name tying up with an entrepreneur who has run a successful business and is seen to be a deal-maker. Access to proprietary deal flow is greatly prized by LPs, and a PE fund manager who has family or business connections that could generate a deal flow will not find it difficult to raise a fund on the back of its deal-making ability alone. Needless to say, the casualty rate among first-time PE fund managers is very high.

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A first-time fund manager may achieve a small ‘friends and family’ raising within two to three months, followed by a second close to bring in high net worth investors and institutional LPs, which will take place between six and 12 months later. Two recent significant fundraising by Singapore-based PE fund managers are Axiom Asia Private Capital’s US$1.028 billion fund to invest in buyout, venture capital, growth capital and other private equity funds and CapitaLand’s US$1.5 billion fund to invest in prime integrated developments in gateway cities in China.

II LEGAL FRAMEWORK FOR FUNDRAISING

The predominant jurisdiction and legal form for a PE fund remain, as has been the case for many years, the Cayman Islands and the exempt limited partnership. The flexibility conferred by the limited partnership structure over the corporate structure is quite well known, and, in addition, the Singapore Companies Act imposes capital maintenance rules that make it restrictive to use the Singapore corporate structure as a vehicle for a PE fund. On the other hand, Singapore-based PE fund managers’ predilection for the Cayman Islands jurisdiction probably stems from familiarity of use of the Cayman jurisdiction rather than any inherent advantage conferred by Cayman laws. Singapore passed its own Limited Partnerships Law in 2009, which, like the Cayman Limited Partnerships Law, is modelled on Delaware’s. Despite this, there has been a slow take-up rate of the Singapore limited partnership form by Singapore-based PE fund managers.

A trend that has been developing is the use of a dual master-fund sub-fund structure, with a limited partnership acting as the pooling master fund and a Singapore-incorporated sub-fund that is wholly owned by the master fund deploying the capital into portfolio companies. This dual structure combines the benefits of the flexibility of the limited partnership with a range of tax-optimisation opportunities offered by the Singapore sub-fund.

Singapore’s network of 81 comprehensive double taxation treaties (DTAs) can be utilised by a PE fund with substantial investments in jurisdictions that have entered into a DTA with Singapore. The following countries with high levels of economic development potential for foreign direct investment have signed a DTA with Singapore: China, India, Indonesia, Malaysia, Myanmar, the Philippines, Russia, South Africa, South Korea, Taiwan, Thailand and Vietnam.

Singapore has also entered into DTAs with OECD countries such as Australia, Canada, France, Germany, Italy, Japan, the Netherlands and the United Kingdom. An institutional fund manager domiciled in any of these OECD countries and sponsoring a PE fund domiciled in Singapore could employ the treaty benefits in a DTA to reduce the incidence of tax on fund management fees received.

For an investment fund domiciled in Singapore and making PE investments in a portfolio company incorporated in a country with a DTA with Singapore, the benefits are diverse. Advantages include the following:

- if a PE fund is domiciled in a jurisdiction that has no treaty with China, any investment by the fund in a Chinese company will be subject to withholding tax of 10 per cent on dividend payments to the fund. If the fund is domiciled in Singapore, owns at least 25 per cent of the equity interests in the Chinese company and submits a confirmation of tax residence issued by the Inland Revenue Authority of Singapore to the Chinese tax authorities, the withholding tax rate will be reduced to 5 per cent under the
China–Singapore DTA. As far as treatment of dividends is concerned, the China–Singapore DTA is as favourable as any other tax treaty signed by China with other jurisdictions, except for that with the Hong Kong Special Administrative Region;

for an investment by a fund in a Chinese company without the benefits of a treaty, all divestment of the shares in the Chinese company will attract Chinese withholding tax of 10 per cent. If the fund is domiciled in Singapore and is a portfolio investor (i.e., it holds less than 25 per cent of the equity interests in the Chinese company), provided that the Chinese company does not derive more than half of its value from holding immovable property in China, the right to tax the capital gains will be ceded to Singapore. Since Singapore does not impose any capital gains tax, the fund will not pay any capital gains tax at all in the divestment; and

under the Singapore–Vietnam DTA, any gains made by a Singapore-resident entity from the assignment of shares in a Vietnamese company (other than shares of a Vietnamese company quoted on a recognised stock exchange of one or both of Singapore and Vietnam, deriving more than 50 per cent of their value directly or indirectly from immovable property situated in Vietnam) will be exempted from capital assignment profits tax in Vietnam, as the right to tax this gain is ceded to Singapore. Due to the fact that Singapore does not have any capital gains tax, if a fund is a Singapore-resident entity, it will not pay any capital gains tax at all in the divestment.

While in structuring a fund the sponsor could interpose an intermediate holding company in Singapore between the fund and the jurisdiction where the investment is made, this does not guarantee that the Singapore intermediate holding company will be able to access the benefits of the DTA. Tax authorities in both developed and developing countries (such as India and China) are increasingly becoming vigilant of, and clamping down on, the practice of tax treaty shopping, and are demanding to see commercial substance in a foreign entity in a contracting state that is claiming benefits under a DTA.

Therefore, it is essential to be able to show that the direct holding company of an investment is not established in a country merely to take advantage of the DTA of its jurisdiction of incorporation. Unfortunately, when investment funds are involved, more often than not there is no commercial substance at all in the jurisdiction where the direct holding company is incorporated. If a fund is incorporated in Singapore and managed out of Singapore as well, it will definitely be easier to show there is commercial substance in the fund. For instance, the board of directors of the fund will not comprise only professional nominee directors, but will include officers actually and actively involved in the management of the fund.

As more countries put in place stricter general anti-avoidance rules to counteract tax treaty shopping, promoters of funds should pay close attention to creating substance when devising investment holding structures. Incorporating a fund as a limited liability company in Singapore that is managed by a Singapore-resident fund manager is one of the best ways to demonstrate commercial substance when planning to access the benefits of a Singapore DTA.

The market practice for the key terms in a PE fund is fairly consistent with the practices in London and New York, and most Singapore-based PE fund managers would accept terms aligned with the Institutional Limited Partners Association’s (ILPA) Private Equity Principles, although there may be no overt agreement to adopt the ILPA template as a starting point. Similarly, the practice of making disclosures to LPs in offering documents is no different from that seen in London and New York.
Prior to the global financial crisis, most PE fund managers would have been able to get away with a ‘deal-by-deal’ carry structure, but a European-style waterfall distribution that minimises excess carry distribution is arguably the norm now.

Regarding fundraising, the PE fund manager will usually place the shares or interests to only high net worth and institutional investors. It will want to avoid the need to prepare a prospectus and to lodge the prospectus for registration with the MAS, and to do so, there are a few ‘safe harbours’ in the Securities and Futures Act (SFA) that can be relied on:

a. where offers are made only to institutional investors as prescribed in the SFA; for example, insurance companies and pension fund managers;

b. where the offers are made only to accredited investors (high net worth individuals and corporations with certain high net worth); and

c. the ‘private placement exemption’, which is available if the offer is made to no more than 50 prospective investors in any 12-month period, subject to aggregation rules.

A first-time PE fund manager usually tries to solicit investors through his or her own contacts without a placement agent. More established PE fund managers typically hire a placement agent, such as a securities brokerage firm or a private bank. Asian family offices that entrust their funds to internationally renowned private banks for management are becoming an important source, if not the most capital source, of funding for Asian PE fund managers.

Under Singapore law, the fund’s sponsor or promoter of a PE fund has no legal responsibility to the LPs other than those undertaken contractually. The GP of a Singapore limited partnership would have a fiduciary duty to the LPs and, unless conflicts of interest are duly disclosed to the LPs and consented to by them, the GP cannot derive a secret profit from its management of the fund or prefer its own interests to the LPs’ collective interests.

### III REGULATORY DEVELOPMENTS

A fund’s sponsor or promoter will invariably rely on one or more of the ‘safe harbour’ exemptions described above from registering a prospectus. As long as a safe harbour exemption is being relied on, there is no regulatory oversight of the fundraising process and the fund is not registered with any regulatory agency.

The available safe havens are:

a. where offers are made only to institutional investors as prescribed in the SFA; for example, insurance companies and pension fund managers; and

b. the ‘private placement exemption’, which is available if the offer is made to no more than 50 entities in any 12-month period, subject to aggregation rules.

If the sponsor or promoter of a fund is unable to rely on one of the above ‘safe harbour’ exemptions, and will be marketing a fund that is structured as a closed-ended fund, as is often the case for PE funds, it will need to note the recent regulatory change that took effect in July 2013, under which closed-ended funds will now be deemed and regulated as restricted collective investment schemes, if, *inter alia*, it falls within the definition of ‘collective investment scheme’ under Section 2(1) of the SFA; all or most of its issued units cannot be redeemed at the election of the unit holders; and it operates in accordance with an investment policy under which investments are made for the purpose of giving participants the benefit of the results of the investments, and not for the purpose of operating a business.
Any offer of units in such closed-ended funds must comply with the requirement to submit a notification and annual declaration to the MAS, as well as furnish an information memorandum that complies with specific disclosure requirements. The matters to be disclosed in an information memorandum issued in connection with an offer of units in such restricted closed investment scheme are:

a the investment objectives and focus of the scheme;
b the investment approach of the manager for the scheme;
c the risks of subscribing for or purchasing units in the scheme;
d whether the offer of units in the restricted scheme is regulated by any financial supervisory authority and, if so, the title and jurisdiction of the legislation under which the restricted scheme is regulated and the name and contact details of the authority;
e whether the manager for the scheme and, where applicable, the trustee or custodian, are regulated by any financial supervisory authority and, if so, the name and contact details of the authority;
f the name and place of incorporation or registration of the manager for the scheme and, where applicable, the trustee or custodian for the scheme;
g in the case of a restricted foreign scheme that is a corporation, its place of incorporation and business address;
h where applicable, the policy of the scheme regarding side letters that may further qualify the relationship between the scheme and selected investors, and the nature and scope of such side letters;
i where applicable, the past performance of the restricted scheme, or where information on the past performance of the scheme may be obtained;
j the details on where the accounts of the scheme may be obtained; and
k the fees and charges payable by the investors and by the scheme.

The only regulatory oversight in the fundraising process is the licensing of any person who carries out a fund management business in Singapore. Prima facie, any person who carries out a fund management business in Singapore needs to be licensed by the MAS or registered by the MAS as a fund manager. A person who provides investment advice relating to a portfolio of securities and who does not make any investment decision on behalf of any client will be regarded as a fund manager by the MAS and regulated as such.

A very significant regulatory development took place in Singapore on 7 August 2012, when a new regulatory regime for fund management companies (FMCs) was introduced. The new regulatory change has introduced a plethora of regulatory requirements that previously did not apply to fund managers in Singapore. There are now three categories of FMCs regulated by the MAS: registered FMCs, licensed accredited and institutional FMCs, and licensed retail FMCs.

Registered FMCs are FMCs whose AUM are not more than S$250 million and that serve not more than 30 qualified investors (of which not more than 15 are funds), which include closed-end funds and collective investment schemes. The underlying investors of such funds must be accredited investors or institutional investors, or both. FMCs that were previously known as exempt FMCs are now known as registered FMCs under the new regime.

Licensed accredited and institutional FMCs are licensed FMCs who serve only accredited and institutional investors. Where the licensed accredited and institutional FMCs manage funds such as collective investment schemes or closed-end funds, then the underlying
investors of these funds must also be accredited investors or institutional investors. Licensed accredited and institutional FMCs will only be able to commence business following the grant of their licence in fund management.

Licensed retail FMCs are licensed FMCs that serve retail investors.

Different regulatory requirements apply to the different categories of FMCs. However, there are also requirements that apply to all FMCs regardless of the category they fall under, which are as follows:

a. all FMCs shall at all times maintain a minimum base capital amount applicable to its fund management activities (as set out below), and are encouraged to maintain an additional capital buffer of the base amount. The following are the applicable minimum base capital requirements:

(i) for FMCs carrying out fund management in respect of any collective investment scheme offered to any investor other than an accredited or institutional investor, the base capital requirement is S$1 million;

(ii) for FMCs carrying out fund management (non-collective investment scheme) on behalf of any customer other than an accredited or institutional investor, the base capital requirement is S$500,000;

(iii) for FMCs carrying out fund management other than that described in (i) and (ii) above, the base capital requirement is S$250,000;

b. all FMCs must have in place compliance arrangements commensurate with the scale, nature and complexity of their operations. The compliance function cannot be carried out by members of the investment team, and may be carried out by an independent and dedicated compliance officer from a related corporation of the FMC. The FMC may also outsource the compliance function to an external consultant who is able to provide meaningful onsite support to the FMC in Singapore;

c. all FMCs must have in place an adequate risk-management framework commensurate with the type and size of investments managed by them. The risk management function must be segregated and independent of the portfolio management function, and the MAS further expects FMCs to be subject to adequate internal audits as conducted by an internal audit function within the FMC, an internal audit team from the head office of the FMC, or an outsourced third-party service provider;

d. all FMCs must ensure assets under their management are subject to independent custody in the hands of regulated prime brokers, depositories and banks. This requirement does not apply to assets in the form of securities that are not listed for quotation on a securities exchange or interests in closed-end funds subject to making certain disclosures;

e. all FMCs must ensure assets under their management are subject to independent valuation, which may be satisfied by having a third-party service provider (such as a fund administrator or custodian) performing the valuation or an in-house valuation function that is independent from the investment management function; and

f. regarding their functions in respect of each fund or account they manage, all FMCs must make certain minimum-risk disclosures that include a valuation policy and performance measurement standards, the use of leverage and the definition and measurement of leverage.

For licensed FMCs, the MAS also requires their officers who perform the actual fund management duties to have a representative licence. In addition to the base capital
requirement, licensed FMCs shall at all times meet the risk-based capital requirement as set out in the Securities and Futures (Financial and Margin Requirements for Holders of CMS2 Licences) Regulations. They must have ‘financial resources’ that are at least 120 per cent of their ‘operational risk requirements’ (both terms as defined in the Regulations). The MAS may impose a requirement to obtain professional indemnity insurance on licensed FMCs that manage monies from retail customers. The MAS may require, where appropriate, licensed FMCs to procure a letter of responsibility from their parent company.

Once an FMC receives a licence, it must receive prior approval from the MAS before it can replace its chief executive officer or appoint a new director, or undergo a change in control. A change of shareholders controlling 20 per cent of the share capital of the licensed FMC is considered as a change in control.

The above requirements do not apply to registered FMCs. Registered FMCs are only required to notify the MAS of the identities of their directors and substantial shareholders at the time of registering themselves with the MAS, and subsequently any change of the same. However, the MAS has the power to revoke a registration if it believes it is in the public interest to do so, and in such event the fund manager would either have to obtain a licence or cease its licensable activity in Singapore.

There is no withholding tax on dividend distributions by a PE fund to non-resident investors. If any interest or royalty is paid by a PE fund to non-resident investors, the withholding tax rates of 15 per cent and 10 percent apply respectively, but PE funds invariably never make any interest or royalty payments to their investors. However, a PE fund domiciled in Singapore is prima facie subject to corporate income tax on its income just like any Singapore-incorporated company.

It is important for any fund to achieve tax neutrality in the jurisdiction where it is domiciled. An investor or sponsor of a fund will not be willing to suffer a tax leakage by virtue of domiciling a fund in a particular jurisdiction, and that is precisely why most investment funds are still domiciled in offshore tax havens today. However, to take advantage of Singapore’s comprehensive network of DTAs, a PE fund must be domiciled in Singapore as a company.

The authorities in Singapore are cognisant of this fact; hence, although Singapore tax-resident entities are subject to an income tax regime at the current rate of 17 per cent, there are special tax exemption schemes available to exempt Singapore-domiciled funds from virtually all incidence of income tax, except where the income is sourced from Singapore immovable properties. Under the tax exemption schemes, it is immaterial whether the Singapore-domiciled funds invest in Singapore or foreign companies.

The latest tax exemption scheme for Singapore-domiciled funds is the ‘Enhanced Tier Incentives’. This is available in parallel with an earlier tax exemption scheme called ‘Basic Tier/Singapore Resident Fund Incentives’.

Under the Basic Tier Scheme, as long as the conditions set out below are met, the fund will be exempted from most forms of Singapore income tax, including the gains or profits realised from the acquisition and divestment of portfolio investments that might otherwise be taxable as trading income. It should be noted that the Scheme will not exempt the fund from income tax arising from the holding of Singapore immovable properties or Singapore-sourced interest.

The conditions under the Basic Tier Scheme are:

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2 Capital markets services.
the fund must be a Singapore-incorporated company and Singapore tax-resident;
the fund must not be 100 per cent beneficially owned by Singapore-resident persons;
the fund must be managed or advised directly by a Singapore FMC and use a Singapore-based fund administrator if the administration is outsourced by the fund manager;
the fund must incur at least S$200,000 in local business spending each year. The expenses can include the fund management fees; and
the fund must not change its investment objective or strategy after being approved for this tax incentive scheme.

Another consideration arising from the Basic Scheme is that ‘qualifying investors’ of the fund will be effectively exempted from all Singapore tax on distributions made by the fund to them. However, there will be a punitive effect on ‘non-qualifying investors’, who shall be required to pay a financial amount to the Inland Revenue Authority of Singapore based on their share of the fund’s income (as reflected in the fund’s audited accounts) multiplied by the corporate income tax rate (currently 17 per cent). The following persons will be regarded as ‘qualifying investors’:

Any person who is not a ‘qualifying investor’ shall be a ‘non-qualifying investor’.

Under the Enhanced Tier Scheme, as long as the conditions set out below are met, the fund will be exempted from most forms of Singapore income tax, including the gains or profits realised from the acquisition and divestment of portfolio investments that might otherwise be taxable as trading income. It is important to note that the Scheme will not exempt the fund from income tax arising from the holding of Singapore immovable properties or Singapore-sourced interest.

The conditions under the Enhanced Tier Scheme are:
The fund must be a Singapore-incorporated company, trust or limited partnership, and Singapore tax-resident;
the fund must have a minimum fund size of S$50 million in committed capital;
the fund must be managed or advised directly by a Singapore FMC and use a Singapore-based fund administrator if the administration is outsourced by the fund manager;
the FMC must employ at least three investment professionals;
the fund must incur at least S$200,000 in local business spending each year. The expenses can include the fund management fees;
the fund must not change its investment objective or strategy after being approved for this tax incentive scheme; and
the fund must not concurrently enjoy other tax incentives.
The key difference between the Enhanced Tier Scheme and the Basic Tier Scheme is that all investors in the Enhanced Tier Scheme will be qualifying investors, and the fund manager of the fund will not have to establish which investors qualify and which investors do not. In practice, this has been a real bonus, as most legal and tax practitioners find it cumbersome to explain the pitfalls of being a non-qualifying investor under the Basic Tier Scheme, which has led to many fund sponsors not embracing the benefits of the Basic Tier Scheme enthusiastically.

IV OUTLOOK

The climate for fundraising for PE funds is as challenging for Singapore-based PE fund managers as it is everywhere, with the impending slowdown in the Chinese economy casting a pall on deal-making in Asia. Despite this, some boutique PE fund managers who target investment in Indonesia and Myanmar are finding success in raising funds.

According to a survey jointly undertaken by PricewaterhouseCoopers and the Singapore Venture Capital Association, PE activity in South East Asia has been growing significantly. In recent years, many Asia-focused funds that had previously channelled their resources solely towards China and India to ride the trend of investments in these booming middle-income consumer markets have recalibrated and turned their attention to South East Asia.

The survey report concluded that Singapore in particular is attractive to PE fund managers because of several key qualities: it has an attractive tax regime and established financial infrastructure; it is increasingly a magnet for talent due to its reputation as a liveable global city; and it is a strategic location with easy access to the rest of South East Asia. According to the authors of the survey, these characteristics provide Singapore with an edge to serve as a regional hub for PE fund managers.

Looking ahead at the regulatory horizon, the Securities and Futures (Amendment) bill 2016 (the Bill) passed on 9 January 2017 introduces legislative amendments to the Securities and Futures Act (Chapter 289 of Singapore) (SFA) to implement policy proposals aimed at ensuring that the capital markets regulatory framework in Singapore keeps pace with market developments and is aligned to international standards and best practices.

The Bill will impact PE fundraising and PE funds in the following areas.

The definition of ‘collective investment scheme’ (CIS) is widened such that there is no need for pooling of investors’ contributions and scheme profits for an arrangement to be regarded as a CIS, as long as the scheme is collectively managed. In collectively managed investment schemes, the investors cede day-to-day control over management of their property, and the MAS is of the view that these participants are exposed to the same risks as a traditional CIS. The operators of such schemes will need to be regulated for carrying out the activity of fund management under the SFA, and the offers of such schemes will subject to the prospectus requirements under the SFA.

The definitions of accredited investors (AIs) and institutional investors (IIs) is refined to better reflect categories of non-retail investors identified based on their wealth or income and financial knowledge respectively. The wealth criteria for an individual to qualify as an AI will be tightened such that the net equity of the individual’s primary residence can only contribute up to S$1 million of the current S$2 million net personal assets threshold. Alternatively, individuals will be able to qualify as an AI if they have S$1 million of financial assets (net of any related liabilities). Individuals whose wealth is concentrated in their primary residence and have few liquid assets otherwise will no longer qualify as AIs. In addition, it
is contemplated that an ‘opt-in’ regime will also be introduced (via subsidiary legislation) to give investors who meet the prescribed AI wealth or income thresholds the choice of benefiting from the regulatory safeguards afforded to retail investors. The II definition will be widened to include persons professionally active in the capital markets, such as financial institutions regulated by foreign regulators, foreign central governments and sovereign wealth funds. However, statutory bodies, other than prescribed statutory boards, will no longer be deemed as IIIs.

The definition of ‘fund management’ is widened. Fund management now includes ‘managing the property of, or operating, a CIS’ and extends to the management of a portfolio of capital markets products (i.e., any securities, units in a collective investment scheme, derivatives contracts, spot foreign exchange contracts for the purposes of leveraged foreign exchange trading, and such other products as the MAS may prescribe as capital markets products).
Chapter 18

SLOVENIA

Gregor Pajek and Urh Šuštar

I GENERAL OVERVIEW

The market of investing in private equity investment funds remained active during 2015 and it may well be said that it has been a relatively prosperous few years for fundraising in the Slovenian market. Slovenian investors show increasing interest in such investments as an alternative to the traditional bank deposits or securities listed on the Ljubljana stock exchange (or any other organised market). Pursuant to the data of the Slovenian Securities Market Agency, the activity on the private equity fundraising market stagnated compared to 2014. Nevertheless, the overall fundraising dynamics in 2015 may still be seen as one of the strongest in recent years. Namely, in addition to the six Slovenian alternative investment fund managers who managed seven alternative investment funds, marketing of 37 alternative investment funds was notified to the Securities Market Agency based on the EU passport (mainly by EU-based fund managers). Marketing of almost half of all the alternative investment funds, which are currently in the fundraising phase, has been notified in 2015 as opposed to the rest being notified from 2013 onwards.

All the private equity funds, which were in the fundraising phase and were registered at the Securities Market Agency in 2015 were managed by various boutique local alternative investment funds managers (AIFM), and managed a portfolio with an approximate value of €15 million. Apart from that, the pivotal part of fundraising activities was conducted by other EU-based AIFMs, who marketed their EU-based alternative investment funds (hereinafter as ‘AIF’). Some notable examples of fundraising are private equity fundraisings lead by EU-based AIFMs Deutsche Alternative Asset Management and KKR Alternative Investment Management, who further strengthened their position on the Slovenian market of private equity fundraising, as they notified the marketing of five newly established alternative investment funds. Further, it is to be noted that an alternative investment fund manager Sankaty Advisors Europe (associated with Bain Capital) entered the Slovenian private equity fundraising market with notification of marketing of two alternative investment funds.

1 Gregor Pajek is a partner and Urh Šuštar is an associate at Rojs, Peljhan, Prelesnik & partners o.p., d.o.o.
3 The estimate is based on the publicly available data for the Slovenia-based alternative investment funds.
II LEGAL FRAMEWORK FOR FUNDRAISING

As of late May 2015 the Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMD) is transposed into Slovenian law by the adoption of two acts creating a new local regulatory framework for private equity fundraising, namely an amendment of the Investment Funds and Management Companies Act (ZISDU-3), which predominantly applies to UCITS funds, and the newly adopted Act on Managers of Alternative Investments Funds (ZUAIS). The latter may be deemed a pivotal act regulating the majority of private equity investment funds’ fundraising apart from ZUAIS investment funds, which invest according to the principles of venture capital, and are further regulated by the Venture Capital Companies Act, which establishes a partially different regulatory regime, which is not described in detail in this chapter. This chapter provides a general overview, and shall thus describe the regulatory framework and market practice with regard to alternative investment funds (AIFs) as the main structural form for private equity fundraising.

i Jurisdiction and legal form

The above-mentioned legal framework provides for a variety of possible structures for an investment fund, which may suit the majority of investment funds. ZISDU-3 governs investment funds, which are designed for the retail market, including UCITS. Nevertheless, the majority of private equity funds according to Slovenian law shall be deemed alternative investment funds and hence are governed by ZUAIS.

A limited liability company structure is the vehicle of choice for most fundraisings of Slovenia-based investment funds. The limited liability company was chosen as the legal form of investment vehicle in all seven investment funds that are registered at the Securities Market Agency and are currently in the fundraising phase in Slovenia. Nevertheless, the majority of EU-based investment funds, the marketing of which was notified to the Securities Market Agency, are structured in the form of limited partnerships according to the law of England and Wales. Only a minority of investment funds marketed and managed on the EU-passport basis are structured as limited liability companies. The reasons Slovenian-based investment funds are not structured as limited partnerships, but rather as limited liability companies, are hard to identify. However, it may be because Slovenian fund managers are more familiar with the limited liability company form and limited partnerships remain largely unused in everyday business practice. Further, the structural inadequacy may be attributed to the fact that the fundraising market is still in its infancy, and that the applicable tax legislation does not provide adequate incentives.

The vast majority of private equity funds, which were marketed on the Slovenian market in 2015 are UK-based, with Slovenia, Ireland, Luxembourg and Austria following. The choice of jurisdiction is currently limited to EU Member States only, as the ZUAIS abolished the
existing private placement regime. Furthermore, the ZUAIS currently limits marketing of non-EU based investment funds and marketing by non-EU based investment fund managers. The jurisdiction for the investment fund is mainly based on investor familiarity, but also taking into account the possible business-friendly and tax-efficient environment.

ii  Key legal terms

The ZUAIS provides for a regulatory framework for two main regulatory types of alternative investment fund (non-UCITS), namely a regime for an AIF and a regime for a special investment fund (SIF). The latter represents a subtype of a general AIF, with certain stricter regulatory requirements.

iii  AIF

The main regulatory regime, which governs the private equity funds, is the one for an alternative investment fund. Generally, there are rather very few limitations in respect to legal structure of the AIF. ZUAIS provides for two main types of legal structure. Firstly, an AIF may be structured as a (separate) pool of assets, whereby the marketable AIF’s unit is the share on such pool of assets. Secondly, if the AIF is structured as a company, shares in the capital of such company are units of the AIF. The units of AIFs structured as companies have to be issued in the legal form of securities\(^{10}\) where an AIF is incorporated as a joint-stock company or in the case of a limited liability company, as business shares (entered into the court or business register of companies).

AIFs are usually managed by an external entity, but may also be internally managed, should the corporate structure of the AIF provide for such possibility and should the management decide not to engage an external AIF manager.

An AIF established and managed as explained above, is not limited in its investment policies. As a counterweight for AIF not to be restricted in its investment policies, the ZUAIS limits the possibility to market such AIF only to professional investors in the sense of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 (MiFID)\(^{11}\) and wealthy private (high net worth) individuals, who are in certain circumstances deemed professional investors. Namely, a private individual shall be considered a professional investor (in the sense of MiFID) if such natural person concludes an agreement with an AIFM, whereby it agrees to invest at least €150,000 into the AIF and signs a statement in a separate document testifying that he or she is aware of the risks in connection with such an obligation or investment.

iv  Special investment fund

A special sub-type of AIF is a SIF. A SIF is an AIF that complies with stricter regulatory requirements and obtains the SIF status on the basis of a decision of the Securities Market Agency. The ZUAIS sets forth certain other additional regulatory requirements relating to the permitted types of investments and levels of exposure either to a single investment or to certain types of investments, and also with regard to the AIFM, which manages such SIF.

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10 In such case an AIFM may be required to issue and/or passport a prospectus in accordance with the applicable laws.
Slovenia

SIF investments abide by the principle of risk diversification, whereby the fund’s exposure to an individual person or a group (entities who are obliged to prepare consolidated accounts) must not exceed 30 per cent of the total net asset value. This limitation does not include different AIFs under the management of the same AIFM, so the SIF which is a fund-of-funds may invest all its assets into its ‘sister’ funds. The SIF may not invest its assets by granting loans or guarantees for loans, however, the SIF may finance companies with mezzanine capital.

The above-mentioned regulatory requirements with regard to the AIFM and to the permitted types of investments result in the additional possibility of marketing the units of such fund to and raising capital from retail investors, provided that the minimum pay-in requirement amounts to €50,000 (instead of €150,000 as in the case of AIFs as explained above).

All the reasons stated above make SIFs an attractive regulatory option in cases when the target investors include predominately retail investors but the formation of UCITS fund or a fund that is essentially similar to the UCITS fund would impose too strict a regulatory regime.

v Key disclosure items
For each of the EU AIFs managed by AIFMs and for each of the AIFs that they market in Slovenia, AIFMs have to make available to AIF investors comprehensive information about the marketed funds. Such information is usually made available in the offering memorandum or in the prospectus, should the AIF’s units be issued in the form of securities.

vi A description of the investment strategy
With the aim of ensuring the prospective investors an informed decision prior to investing in the AIF, the ZUAIS prescribes that the AIFM must disclose a set of information. Primarily, the disclosure must include a description of the investment strategy and objectives, the types of assets in which the AIF may invest, the techniques it may employ, along with all associated risks, any applicable investment restrictions, the jurisdiction of establishment of any master AIF and of the underlying funds if the AIF is a fund of funds.

AIFM also has disclose also the circumstances in which the AIF may use leverage, the types and sources of leverage and the associated risks, any restrictions on the use of leverage and any collateral and asset reuse arrangements, and the maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF.

In addition to the above, the offering memorandum also has to include a description of the procedures by which the AIF may change its investment strategy or investment policy.

vii Financial data
The AIF also has to disclose financial information. This information comprises the latest annual report and, where available, the historical performance of the AIF.

The disclosure must also contain the latest net asset value of the AIF or the latest market price of the unit or share of the AIF. In addition to the net asset value, an AIF’s valuation procedure and the pricing methodology for assets valuation (including the methods used in valuation of hard-to-value assets) have to be disclosed.
viii Risks
Furthermore, the investors have to be provided with a description of the AIF’s liquidity risk management, including the redemption rights both in normal and exceptional circumstances, and the existing redemption arrangements with investors. Apart from the information, the required disclosure also includes information on how the AIFM is managing professional responsibility risks.

ix Legal information and information about the entities engaged in the fundraising
The disclosure in the offering memorandum has to contain a description of how the AIFM ensures a fair treatment of investors. To the extent an investor obtains preferential treatment or the right to obtain preferential treatment, a disclosure must include a description of such preferential treatment, the type of investors entitled to obtain such preferential treatment and, where relevant, their legal or economic links with the AIF or AIFM. In cases where the AIFM delegated the management function or any part thereof or the depositary delegated any of its function, such delegation has to be disclosed.

The disclosure must also contain a description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, on the applicable governing law and legal instruments ensuring recognition and enforcement of judgements in that jurisdiction.

x Procedure and costs
The investors also have to be informed about the procedure and conditions for the issue and sale of units or shares of the AIF that is being offered. This disclosure includes the identity and details of the prime broker, depositary, auditor and other contractually engaged partners, including the conflicts of interest policy and about transfer of liability.

The offering memorandum must include a statement of all fees, charges and expenses and of the maximum amounts thereof, which are directly or indirectly borne by investors.

xi Additional information
To the extent the AIF is required to publish a prospectus in accordance with the Financial Instruments Market Act (ZTFI) and MiFID, the majority of information required to be disclosed under the ZUAIS is already a part of the prospectus (issued in connection with the AIF’s securities). If the prospectus does not include all the necessary information as explained above, the missing information can be disclosed in a separate document (as schedule to the prospectus or an independent offering document).

xii Methods of solicitation and reverse solicitation
Methods of solicitation
The regulation of marketing of AIFs set forth in the ZUAIS requires the marketing entity to be duly authorised for marketing of AIFs on the Slovenian market (it may obtain a permit for marketing by the Securities Market Agency or notify the marketing on the basis of the EU passport).

12 Official gazette of the Republic of Slovenia No. 108/10 – official consolidated text, 78/11, 55/12, 105/12 – ZBan-1J and 63/13 – ZS-K.
Provided that the AIFM is authorised to conduct marketing services it may use methods such as unsolicited telephone calls (cold calls), unsolicited written correspondence and materials, responding to requests for proposals, responding to reverse enquiries, industry events (where entrance may be restricted to certain types of investors), multi and single-client meetings (i.e., face-to-face meetings between the AIFM and one or more clients). Furthermore, Slovenian law does not impose any limitations upon the marketing entity with regard to the content of the materials used in the marketing activities, as long as the content does not represent an unfair competition practice.

In the fundraising phase, two sets of promotional activities should be distinguished on the Slovenian market. The first set of promotional activities are those that do not represent marketing of AIFs in the sense of the ZUAIS. The second set are promotional activities that offer more precise information regarding the AIFs offered and are thus deemed as marketing of AIFs. For example, the AIFM or other marketing entity shall not be deemed to undertake marketing activities in the sense of the ZUAIS if it includes in its promotional content some factual information and opinion about the private markets industry, factual information about the AIFM (including track record information) and deal examples (which can include actual or expected returns). In such case, the activities do not require any kind of permit of the Securities Market Agency or notification through another EU Member State (i.e., 'home Member State').

On the other hand, if the promotional or marketing material consists of details of funds available for investment or offer documents, such as offering memoranda and subscription agreements, such activities shall be deemed marketing and hence such conduct requires the AIFM to be duly authorised or notified, as applicable.

Reverse solicitation

A considerable amount of fundraising in Slovenia is conducted via reverse solicitation, and the Securities Market Agency adopted a level 2 regulation (detailing the ZUAIS), which (inter alia) also defined the reverse solicitation. Reverse solicitation is often used by foreign-based investment fund managers in cases where a major Slovenian company active in the financial sector seeks suitable investments for excess liquidity.

The above-mentioned level 2 regulation sets forth a definition of 'reverse solicitation' in Article 6, in the following wording: 'It is considered that the transaction has not been concluded on the initiative of the manager, if the investor confirms in a written statement before the offer that it has acquired units of an AIF at its own initiative and that the transaction is the result of the investor's request for the purchase of AIF that investor identified in advance.' The definition of reverse solicitation as in force leaves the doors for non-EU or non-authorised managers wide open, so they may reach potential major Slovenian investors on the basis of reverse solicitation.

Fiduciary duties of the fund’s sponsor to the investors

Slovenia-based investment funds that have been registered at the Securities Market Agency do not differentiate between the managing entity (i.e., the AIFM) and the sponsor. The roles of these two entities are usually embodied in one entity, as Slovenia-based investment funds take the legal structure of a limited liability company and not a limited partnership (in which the AFIM would be the partner with unlimited liability), so there is no practical need for
such separation. The fiduciary duties described hereunder thus usually apply to the AIFM in the case of Slovenia-based investment funds and to the sponsor, if the AIF's management employs that kind of legal structure.

The first group of fiduciary duties that are imposed upon the AIFM by the ZUAIS relates to the obligation to act fairly, professionally, with all due diligence and in the best interests of the AIF under its management and of the investors in those funds.

The second group of fiduciary duties includes the AIFM's obligation to possess and effectively employ the resources and procedures necessary for proper performance of its business activities. Proper performance of the business activities also includes the obligation to adopt reasonable measures to avoid conflicts of interest, or if they cannot be prevented, to ensure that those conflicts are identified, managed and monitored and, where appropriate, disclosed so that they would not adversely affect the interests of the AIF.

III REGULATORY DEVELOPMENTS

In 2015, the AIFM Directive has been fully implemented into Slovenian legal order by adopting two separate acts, namely the ZUAIS and an amendment of the ZISDU-3. The renewed legal framework defines the Slovenian Securities Market Agency as the competent authority for the oversight of the financial markets and hence also of the formation and fundraising of the private equity funds. The ZUAIS conferred an obligation and power to the Securities Market Agency to adopt certain level 2 regulation, by which certain aspects are further determined and are intended to make the renewed regulatory framework fully functional.

Registration of sponsors and of private equity funds

An external manager of the AIF has to obtain a special permit from the Securities Market Agency if it exceeds a certain thresholds. Namely, Article 38 ZUAIS sets forth that the permit is mandatory if the AIFM either directly or indirectly manages portfolios of AIFs whose assets under management, including any assets acquired through use of leverage, in total exceed a threshold of €100 million; or, alternatively, when the managed assets in total exceed a threshold of €500 million to the extent the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF. An EU-based AIFM may also market and manage the AIFs under its management on the grounds of EU passport, whereby the AIFM obtains all the necessary approvals with the competent authority of its home Member State, and only notifies managing and marketing with the Securities Market Agency, as the competent authority in Slovenia. EU passporting in Slovenia is also available to sub-threshold AIFMs that obtained the permit with the competent authority in the home Member State on the voluntary basis.

If the AIFM exceeds the above-described thresholds, the ZUAIS (as the pivotal statute) in the field of private equity fundraising provides three separate regimes regulating AIFMs and AIFs, whereby the main distinguishing factor in determination of which of the three regimes shall be applied is the country where the AIFM or AIF are based. Upon determination of the country of origin, different levels of regulation apply in the cases, if the country of origin is Slovenia, or EU Member State or a third (non-EU) country. This legal framework terminated all of the existing private placement regimes, and should the AIFM or AIF endeavour to be present on the Slovenian market, this may be done solely according to the legal framework set forth by the ZUAIS.
If the AIFM is based in Slovenia, the ZUAIS requires firstly the AIFM to obtain a special permit issued by the Securities Market Agency that may be obtained for the management of the AIFs or only for the marketing (in such case the requirements are not so demanding). If the AIFM obtains such permit, it may commence the marketing of the AIF upon the notification of marketing to the Securities Market Agency.

To the extent the AIFM and the AIF are based in another EU Member State (i.e., their ‘home Member State’) the requirements attached to the commencement of managing and marketing functions differ to a great extent. In such case an EU-based AIFMs are entitled to manage the AIFs and to market them on the basis of the EU passport. The authority, competent for a full-scope supervision, is the one of the home Member State, and the ZUAIS requires only that the Slovenian Securities Market Agency is notified of such marketing activities on the Slovenian market. The notification process is carried out in front of the competent authority of the home Member State, who later communicates all the necessary documentation and permit to the Slovenian Securities Market Agency.

The third regulatory framework applies if the AIFM or AIF are non-EU based. However, the legal regime governing management and marketing of non-EU AIFs and non-EU AIFMs is not yet in force and shall become valid when the European Commission adopts an implementing regulation pursuant to Paragraph 6 of Article 67 AIFMD. Until that time, there is no possibility of marketing a non-EU AIF that is managed by an EU or a non-EU AIFM in Slovenia (save for the cases of reverse solicitation).

**ii Taxation**

Under the Slovenian Corporate Income Tax Act, Slovenian investment funds and other investment funds with tax residency in Slovenia are effectively exempt from payment of corporate income tax (the applicable tax rate is zero per cent), under the condition that the investment fund distributes at least 90 per cent of the previous year’s profits to the investors until the end of November of the relevant fiscal year. If the investment fund is a venture capital fund, the tax exemption applies regardless of the above-mentioned condition for the profits achieved from its venture capital investing activities.

Since the above-mentioned framework applies explicitly to UCITS, venture capital companies (established under the Slovenian Venture Capital Companies Act), certain pension funds and insurance companies (to the extent of they perform pension plans as a business activity), it is still uncertain if the zero per cent tax rate applies also to AIFMs established under the ZUAIS. In the absence of an explicit statutory provision it could also be argued that such tax exemption does not apply to AIFMs established under the ZUAIS – this would then result in an obligation to pay corporate income tax at the rate of 17 per cent of the taxable profit. Such situation obviously calls for a revision of the Corporate Income Tax Act and its amendment in order to include AIFMs under the zero per cent tax rate exemption.

If the investors in Slovenian investment funds are companies with their tax residency in Slovenia, the profits achieved from the units or shares in the investment fund are subjected to the Corporate Income Tax, which is payable by the corporations with a tax residency in Slovenia and which amounts to 17 per cent of the taxable profits.

If the investors in Slovenian investment funds are natural persons with a tax residency in Slovenia, they are generally subject to income taxation pursuant to the Personal Income Tax Act with respect to proceeds received from the funds and with respect to profits achieved from the sale of the units or shares in such funds. The applicable taxation rate is 25 per cent of the profits (dividends).
IV OUTLOOK

As of 2015, the AIFMD has been fully transposed into Slovenian legal system, whereby the renewed legal framework became fully functional on 10 February 2016, when the Securities Market Agency adopted all the necessary level 2 regulations. Nevertheless, Slovenia’s legal order does not provide for a possibility for a fund manager or fund that is based in a third country (non-EU member) to conduct any fundraising on the Slovenian market due to the fact that the newly adopted legislation chose to terminate the existing private placement regimes (except in cases of reverse solicitation). Managing and marketing of non-EU-based managers or investment funds shall be permitted upon the adoption of a delegated regulation according to Article 67 AIFMD by the European Commission.
Chapter 19

SOUTH AFRICA

Johan Loubser, Jan Viviers and Magda Snyckers

I GENERAL OVERVIEW

The private equity industry in South Africa is among the most established in emerging markets and has fund types that vary by fund vehicle, investment stage, size and sector specialisation. With respect to the size of the industry, at the end of 2015 (the most recent year for which data is available) the industry employed around 489 investment professionals and had funds under management of approximately 165.3 billion rand (excluding investments managed by the Public Investment Corporation), located both locally and abroad. The membership of the local industry association, the South African Venture Capital Association (SAVCA), includes more than 80 fund manager firms. These numbers include fund managers who raise funds from third parties and fund managers who manage on-balance sheet investments for banks, insurance companies, investment holding companies and government development agencies. At the end of 2015, fund managers managing third-party funds had approximately 101.1 billion rand of assets under management and undrawn commitments of approximately 34.7 billion rand. The amount raised from third parties during the 2015 calendar year was estimated to be 29 billion rand, earmarked mostly for late-stage developments. The South African private equity industry is dominated by a small number of independent fund managers who can point to their successful historical track records, although there are also a fair number of promising new players and fund managers affiliated with local banks and insurers.

While private equity fundraising activity and the success rate thereof has not returned to 2006–2007 levels, the relatively expensive level of equities on the Johannesburg Stock Exchange, regulatory acceptance of investment by South African pension funds in private equity funds, the South African government’s renewable energy programme, the need for

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1 Johan Loubser, Jan Viviers and Magda Snyckers are directors at ENSafrika.
4 SAVCA Survey, 2016, p. 17.
5 SAVCA Survey, 2016, p. 27.
banks to reduce their loan books, infrastructure requirements and the economic growth enjoyed by some sub-Saharan African countries are fuelling renewed interest in private equity investment.

There is also an increase in funds raised outside South Africa and which will invest in other sub-Saharan African countries, but which will be managed by managers with strong links to South Africa. Investors in such funds typically include international development finance institutions and, increasingly, South African institutional investors.

Significant recently publicised fundraising activity relating to fundraising by fund managers from third parties included the following:

a. Ethos Capital Partners recently raised 1.8 billion rand by listing on the Johannesburg Stock Exchange in a private placement in August 2016.6

b. Enko Capital Managers announced the final closing of its Pan-African Fund, the Enko Africa Private Equity Fund at US$83.25 million in 2016. Investors include Proparco, a collection of European investors managed by Massena Partners, as well as the African Development Bank, Soros Brothers Investments and various institutional, family office and high net worth investors.7

c. Investec Asset Management successfully closed the Investec Africa Private Equity Fund 2 (IAPEF 2) at US$295 million in early 2016 and the Investec Africa Credit Opportunities Fund I at US$226.5 million in 2015.8

d. Metier Capital achieved the first close of its Metier Capital Growth Fund II in February 2015 and completed further closings in June 2016, raising in excess of 2.5 billion rand, with further commitments expected by final closing. The fund’s investors include Dutch and German development agencies. The fund targets investments in South Africa and other sub-Saharan countries in a range of sectors, including transport and logistics, retail, health, tourism, education, fast-moving consumer goods, agri-processing and infrastructure services.9

II LEGAL FRAMEWORK FOR FUNDRAISING

As mentioned in Section I, supra, the South African private equity industry includes significant on-balance sheet investment by special purpose acquisition companies, insurance companies, banks, investment holding companies and government agencies and institutions. For example:

a. Special purpose acquisition companies are permitted to list on the Johannesburg Stock Exchange (JSE). Such a company may not carry on any commercial or business operations at the time of its application for a listing,10 but must within 24 months from

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10 JSE Listings Requirements 4.34(a).
the date of its listing\textsuperscript{11} acquire assets meeting the qualifying criteria of the main board or the alternative exchange (AltX) of the JSE.\textsuperscript{12} In order to list on the main board of the JSE an applicant must raise at least 500 million rand through the issue of shares. A minimum of 50 million rand must be raised for a listing on the AltX.\textsuperscript{13} All capital raised must be held in escrow with an escrow agent until acquisitions of qualifying assets are made.\textsuperscript{14} We anticipate that this type of vehicle, together with investment entities (discussed below) may in future be used as an alternative to the more traditional private equity funds structures.

\begin{itemize}
  \item In addition, entities whose principal business is investment in securities are permitted to list on the JSE. Such an investment entity could, for example, purchase existing private equity fund portfolios and serve as a vehicle through which investors could gain long-term exposure to portfolio companies while enjoying the benefit of increased liquidity.\textsuperscript{15}
  \item Long-term insurance companies hold large unlisted investments on their balance sheets, often on account of linked policies issued to policy holders on the basis that the policy proceeds will be equal to the realisation achieved with respect to the ‘linked’ unlisted investments, less costs and taxes. It is common for such insurers to group such unlisted assets together in a portfolio managed by a specialised asset manager, and for policies linked to such portfolio to be managed as if the portfolio was held in a separate pooled fund vehicle.
\end{itemize}

The legal, tax and regulatory framework within which the above-mentioned industry participants raise and invest funds are not discussed below. The focus of this chapter is on fundraising by fund managers from third parties who invest into more traditional closed-ended funds domiciled in South Africa and that are governed by South African law and also on certain tax and exchange control issues arising for South African investors into foreign domiciled funds.

\textbf{i} South African private equity structures

The principal vehicle housing South African private equity funds investing in South Africa is the limited liability partnership (called \textit{en commandite} partnerships). A trust structure (called a \textit{bewind} trust) is also sometimes used. The main reasons for the use of these entities to house funds are the following:

\begin{itemize}
  \item they permit the income and capital gains of the fund to be taxed in the hands of investors according to the tax profile of each investor;
  \item they provide investors with limited liability, so that an investor will not have liability exceeding its contractual commitment to the fund;
  \item they are not subject to cumbersome regulatory oversight and can be established with relative ease;
  \item they allow the day-to-day affairs of the fund and all operational matters to be outsourced, which permits the fund manager a high degree of autonomy; and
\end{itemize}

\begin{thebibliography}{11}
\bibitem{11} JSE LR 4.35(a).
\bibitem{12} JSE LR 4.33 – see definition of ‘Viable Assets’.
\bibitem{13} JSE LR 4.34(g).
\bibitem{14} JSE LR 4.34(h).
\bibitem{15} JSE LR 15.
\end{thebibliography}
they permit the use of the types of contractual terms and organisational practices that are commonly used internationally.

**Limited liability partnership**

An *en commandite* partnership is established by contract. The contract between the parties should expressly reflect the intention of establishing an *en commandite* partnership and should expressly identify the general or disclosed partner.16 There are no registration requirements for establishing, and no legislation regulating, *en commandite* partnerships. An *en commandite* partnership is carried on by one or more partners, called the general or managing partner or partners, to which every partner whose name is not disclosed, called a commanditarian partner or partner *en commandite*, contributes a fixed sum of money on condition that he or she receives a certain share of the profit, if there is any, but that in the event of loss he or she is liable to his or her co-partners to the extent of the fixed amount of his or her agreed capital contribution only. Commanditarian partners:

- *a* are not presented as partners (and accordingly, persons dealing with the partnership do not form the mistaken impression that they are entitled to rely on the credit of the commanditarian partner);
- *b* are not liable for partnership debts to creditors of the partnership, but only to their co-partners (and therefore enjoy the benefit of limited liability);
- *c* may not participate actively in the business of the partnership (although the commanditarian partner may be entitled to advise the managing partner and may also enjoy limited consent rights); and
- *d* cannot claim repayment of their contributions or payment of their share of the partnership profits in competition with the creditors of the partnership.17

The general partner of the *en commandite* partnership has unlimited liability toward creditors of the partnership in circumstances where the partnership’s assets are insufficient to settle relevant debts. The *en commandite* partnership usually terminates by agreement between all the partners or in accordance with the terms of the partnership agreement, which may, for example, provide that the general partner may terminate the partnership on notice to the other partners. All commercial aspects of the partnership, such as profit share arrangements, permitted expenses, investment restrictions and so forth, are usually contained in the partnership agreement. The partners have wide discretion to arrange their affairs in the partnership agreement in accordance with their commercial intentions, provided that the partnership adheres to the requirements for an *en commandite* partnership (and subject to general requirements for enforceable contracts, such as the requirement that the terms of the agreement should be sufficiently certain). The terms of the partnership agreement are not publicly available. *En commandite* partnership agreements usually provide for the removal and replacement of the general partner. In terms of common law legal requirements, such removal and replacement would usually require the consent of all creditors of the *en commandite* partnership.

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17 Id., Paragraph 258.
**Bewind trust**

A bewind trust differs from other forms of trusts under South African law in that the trustees do not own, but merely hold and administer, the assets of the trust that are owned in undivided shares by the beneficiaries of the trust.\(^{18}\) The trust property does not form part of the estate of the trustee\(^ {19}\) except insofar as the trustee is a beneficiary. The trust is established by way of a trust deed. Copies thereof may be requested from the Master of the High Court by any person who has, in the opinion of the Master, sufficient interest therein.\(^ {20}\) The trustees may not act as such until they have been authorised to do so by the Master\(^ {21}\) after following a simple registration process. The Master has limited regulatory powers in relation to the trust in terms of the Trust Property Control Act 1988 and may, for example, in certain instances remove the trustee or apply to court for his or her removal.\(^ {22}\)

**Fund organisation**

In the South African context, the vehicle housing the private equity fund (whether a partnership or a trust) would typically appoint the fund manager or adviser in terms of a written mandate to manage the day-to-day affairs of the fund and to identify and execute investments and disinvestments. Increasing use is also made of independent valuators.

Although practice varies, the fund manager or adviser would not always have direct contractual obligations to specific investors (save if created by way of a side letter) and would in many cases only owe contractual obligations to the trust or partnership housing the fund.

Although it is standard practice for the attorneys advising on the establishment of the fund to issue an opinion confirming that the applicable agreements have been duly authorised and are lawful, valid and enforceable, such opinion is often given to the fund rather than applicable investors.

The matters typically addressed in the applicable trust deed or partnership agreement have, over time, to a large extent become standardised. Investors in a South African private equity fund could expect contractual provisions dealing with the following matters, among others:

- a minimum investment requirement for the fund manager, adviser or associate;
- the admission of further investors following the first closing;
- time periods for the making of investments and disinvestments by the fund;
- investor default;
- guidelines, requirements and prohibitions relating to investments;
- the composition and functions of the investor advisory board;
- reporting requirements;
- key personnel assurances during and after the commitment period;
- conflicts of interest;
- co-investments;
- allocation of expenses;
- distributions (including whether distributions must be in cash and clawback provisions);

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19 Section 12 of the Trust Property Control Act 1988 (the Trust Property Control Act).
20 Section 18 of the Trust Property Control Act.
21 Section 6(1) of the Trust Property Control Act.
22 Section 20 of the Trust Property Control Act.
carried interest (in this regard, investors increasingly insist that the carried interest be calculated over the life of the fund and that distributions of carried interest be kept in escrow);
fees of the adviser or fund manager;
replacement of the fund manager;
limitations of liability for managers;
termination of the fund;
side letters; and
requirements in respect of valuations.

ii Marketing of South African private equity funds

Investors commit to the fund by signing deeds of adherences to the partnership agreement or trust deed, as the case may be. Fundraising is typically organised by the fund manager, and in some cases investors are introduced to the fund by way of the distribution of a short-form private placement memorandum, which functions as a summary of the applicable terms. The key matters disclosed in such a memorandum would include the historic success of the fund manager, the fees payable to the fund manager, any carried interest arrangements, and whether any investor commitments have already been received and the amount thereof. In addition, the list of conditions for investment in private equity funds (see Section III.ii, infra) applicable to South African pension funds contains a checklist of prescribed due diligence matters that a pension fund must consider before investing in a private equity fund. It is likely that future private placement memoranda will be structured in order to provide comfort in relation to the items on this prescribed checklist.

Partnerships and trusts could in theory satisfy all of the requirements of a collective investment scheme and fall to be regulated as such in terms of the Collective Investment Schemes Control Act 2002 (CISCA) if ‘members of the public’ are invited and then permitted to invest. Since there is currently no licensing scheme in place to regulate private equity funds under the CISCA, triggering the application of the legislation by inviting or permitting members of the public to invest in the fund could result in the fund being unlawful and persons involved in the administration of the fund being criminally liable. This reason, it is not advisable for any person to advertise investment opportunities in a private equity fund in the press or for private placement memoranda to be made available indiscriminately. Moreover, although the statutory limit on the number of partners in a partnership was abolished in 2011, it remains prudent to limit the number of investors in the fund in order to counteract any suggestion that ‘members of the public’ are permitted to invest, but there is no bright line as to how many partners or investors would be too many. One way of permitting a larger number of investors to invest is for an insurance company to invest in the private equity fund and then to permit policy holders to share in the performance of the investment through ‘linked policies’.

There is a measure of uncertainty and debate as to whether the investor’s partnership interest or interest in a bewind trust housing a private equity fund would constitute a ‘financial product’ under the Financial Advisory and Intermediary Services Act 2002 (FAIS). If so, then persons who provide advice in respect thereof to potential investors or otherwise provide an

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23 See Sections 5 and 115(b) of CISCA.
24 The Companies Act No. 71 of 2008 does not contain a prohibition similar to that contained in Section 30 of the Companies Act No. 61 of 1973.
intermediary service in relation to any such investment as a regular feature of their business may fall under the regulatory ambit of the FAIS. The uncertainty arises because, although the applicable partnership or trust interest would provide the investor with undivided ownership (together with other investors) in the shares of portfolio companies (which are indeed ‘financial products’), the partnership or trust interest itself is not a ‘security’ or ‘instrument’, although it could amount to a ‘combined product containing’ financial products, such as shares.25 Given this uncertainty, the prudent approach is to limit marketing of the applicable interest within South Africa to financial services providers authorised under the FAIS. As will be seen below, the fund manager is usually so licensed.

Where the FAIS applies, it imposes the duty on the relevant financial services provider to render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry.26 Apart from the FAIS, the fund manager or other promoters could potentially attract contractual or delictual liability pursuant to, for example, non-performance, negligent misrepresentation or fraud. There is no well-developed body of case law dealing with such liability in the context of private equity funds.

iii Investment clubs

A new trend, which has proven to be successful in the United Kingdom, is also being adopted in South Africa. This entails the formation of an investors’ club or circle of persons who are usually high net worth individuals, although there is no reason why this structure cannot include institutional investors. In this structure, investors pay an annual fee to the investors’ club, which is managed by the private equity fund manager, and in return are afforded the opportunity to invest in investment opportunities identified by the fund manager and brought to the investors’ club. Investors are not required to provide committed capital and can elect which investment opportunities they wish to participate in, subject to certain rules of the investors’ club. Each investment would typically be housed in a separate en commandite partnership or bewind trust. This structure is flexible and gives investors greater control over the particular investments making up their bouquet of investments.

iv Tax and exchange control

To encourage the use of South Africa as a springboard for investment into Africa, the government has over the past few years made significant changes to the country’s tax and exchange control regime, which was in the past fairly unfavourable to outward investment and to the management of offshore investments from South Africa. Such changes include various amendments to the tax legislation to prevent the activities of South African investment managers from causing the investments of non-South African investors to be taxed in South Africa.

**General principles**

Both en commandite partnerships and bewind trusts constituted in terms of South African law are fiscally transparent vehicles for South African tax purposes. All of the tax implications

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25 Definition of ‘financial product’ in Section 1 of the FAIS.
in respect of the underlying investments of the fund will accordingly arise directly in the hands of the relevant investors. In addition, a ‘foreign partnership’, as defined in the Income Tax Act, is a fiscally transparent entity.\textsuperscript{27}

South African investors in such partnerships, foreign partnerships or trusts will be required to include income generated in respect of the underlying assets in their gross income and will be taxed in accordance with the tax regime applicable to such investors. Dividend income on shares in South African companies will generally be exempt from income tax in South African investors’ hands\textsuperscript{28} (subject to certain exceptions in respect of, \textit{inter alia}, preference share type investments and lending arrangements),\textsuperscript{29} while any dividends\textsuperscript{30} on shares in non-South African companies or interest income will generally be subject to income tax in South African investors’ hands. Dividends on shares in South African companies and cash dividends on shares in non-South African companies listed on the JSE may be subject to dividends tax, subject to certain exemptions that may depend on the nature of the investor (e.g., if the investor is a South African tax resident company, the dividend should be exempt from dividends tax).\textsuperscript{31} Certain documentary requirements must be met in order to rely on exemptions from, or reductions in the rate of, the dividends tax. Specific anti tax-avoidance provisions exist, which may deem interest payments on a debt instrument that qualifies as a ‘hybrid debt instrument’ or interest that qualifies as ‘hybrid interest’ to be dividends in specie and taxed accordingly.\textsuperscript{32} A South African investor into a ‘foreign partnership’ may be required to include a notional amount equal to the net income of any controlled foreign company (CFC) into which the partnership invests in its income and be taxed on such inclusion, subject to one of the exemptions or exclusions to the CFC rules not applying.

\textsuperscript{27} See Section 1 of the Income Tax Act No. 58 of 1962 (the Income Tax Act).
\textsuperscript{28} See Section 10(1)(k)(i) of the Income Tax Act.
\textsuperscript{29} The Income Tax Act deems the dividends on certain shares containing debt-like characteristics to be income in the hands of the recipient. In terms of the Taxation Laws Amendment Bill, 2016 (the 2016 Bill), it is proposed that these provisions should not only apply to certain shares containing debt-like characteristics, but also to a right or interest the value of which is determined directly or indirectly with reference to such shares or an amount derived from such shares. These rules, found in Sections 8E and 8EA of the Income Tax Act, have been subject to extensive amendments over the past few years. The amended rules impact, among others, on the type of security arrangements that may be utilised in respect of preference share funding as well as the purpose for which the funding may be utilised.
\textsuperscript{30} South African investors are required to include foreign dividends in their income. Certain exemptions (see Section 10B of the Income Tax Act) are available in respect of foreign dividends. The general exemptions achieve an exemption of foreign dividends to the extent that the foreign dividend is effectively only subject to income tax at a rate of 15 per cent (which equates to the dividends tax rate in respect of dividends distributed by South African companies). In certain instances the full foreign dividend may be exempt, for example where the South African resident holds at least 10 per cent of the equity shares and voting rights in the foreign company and subject to certain provisos and exclusions not applying.
\textsuperscript{31} The dividends tax regime was introduced on 1 April 2012 and is contained in Part VIII of the Income Tax Act. Dividends tax is levied at a rate of 15 per cent, subject to certain exemptions, and a reduction of such rate in terms of any applicable treaty.
\textsuperscript{32} See Sections 8F and 8FA of the Income Tax Act. In terms of the 2016 Bill, it is proposed that these anti-avoidance provisions should only apply in instances where the issuer of the debt instrument is (1) a resident company, or (2) a non-resident company if the interest in respect of that instrument is attributable to a permanent establishment of that company in South Africa, or (3) a company that is a controlled foreign company (CFC) if the interest incurred in respect of that instrument must be taken into account in determining the net income of that CFC as contemplated in section 9D of the Income Tax Act.
Non-South African investors will only be required to include income generated in respect of the underlying assets in their gross income if the income is from a South African source.\textsuperscript{33} This will be the case, \textit{inter alia}, in respect of interest on loans applied in South Africa and dividends on shares in South African tax resident companies or interest that is deemed to constitute dividends.\textsuperscript{34} Such dividends will generally be exempt from income tax in the non-South African investors’ hands\textsuperscript{35} (subject to certain exceptions in respect of preference share-type investments and lending arrangements).\textsuperscript{36} Any interest income should be exempt from income tax in the non-South African investors’ hands, unless it is a natural person investor who has been physically present in South Africa for more than 183 days in aggregate in the 12-month period preceding the date on which the interest was received or accrued, or if the debt from which the interest arises is effectively connected to a permanent establishment of the non-South African investor in South Africa.\textsuperscript{37} This exemption would not apply to interest which is deemed to be a dividend as the provisions relating to dividends would apply. Provided certain requirements are met, the actions of the general partner or trustees should not result in the non-South African resident investor having a permanent establishment in South Africa for purposes of the Income Tax Act.\textsuperscript{38} Any dividends declared by a South African company and interest deemed to be a dividend or interest from a South African source that is paid to a non-South African resident investor will be subject to dividends tax\textsuperscript{39} and, with effect from 1 March 2015, interest withholding tax,\textsuperscript{40} respectively (subject to certain exemptions and any available treaty relief). Certain documentary requirements must be met in order to rely on certain exemptions from, or reductions in the rate of, dividends tax and the interest withholding tax.

Any gains in respect of a disposal of the underlying assets may give rise to income tax or capital gains tax implications in the hands of the South African investors, depending on whether the investor trades in the underlying assets or not, which will be taxed in accordance

\textsuperscript{33} See the definition of ‘gross income’ in Section 1 of the Income Tax Act.
\textsuperscript{34} Historically, the Income Tax Act did not provide specific source rules, which were determined largely with regard to tests laid down by the courts. With effect from 1 January 2012, certain deemed source rules were introduced in Section 9(2) of the Income Tax Act. These rules provide, \textit{inter alia}, that dividends distributed by South African companies and interest on loans attributable to an amount incurred by a South African resident, or that are received or accrue in respect of the utilisation or application in South Africa by any person of any funds or credit, will be deemed to be from a South African source. See footnote 32.
\textsuperscript{35} See footnote 42.
\textsuperscript{36} See footnote 29.
\textsuperscript{37} See Section 10(1)(h) of the Income Tax Act.
\textsuperscript{38} The definition of ‘permanent establishment’ in Section 1 of the Income Tax Act has been amended with effect from 1 January 2011 to exclude the activities of certain general managers and trustees from creating a permanent establishment for qualifying investors. A ‘qualifying investor’ is a defined concept – see Section 1 of the Income Tax Act.
\textsuperscript{39} See footnote 30.
\textsuperscript{40} With effect from 1 March 2015, interest withholding tax is levied at a rate of 15 per cent on the amount of any interest that is paid by any person to or for the benefit of any foreign person to the extent that such amount of interest is from a South African source. Exempt from the interest withholding tax is any amount of interest that is, \textit{inter alia}, paid in respect of any listed debt; or paid by the South African government, any bank or the South African Reserve Bank. An additional exemption from the interest withholding tax has recently been introduced with effect from 1 March 2015 in terms of which South African sourced interest paid to a non-resident in respect of a debt owed by another non-resident is exempt from this withholding tax provided that the exclusions to the exemption do not apply.
with the tax profile of the applicable investor. Generally, non-resident investors will only be subject to South African tax in respect of such disposals if they have a permanent establishment in South Africa (see above).41

An *en commandite* partnership and a bewind trust can give rise to complexity from a tax perspective in respect of exiting partners or the admission of new partners. This is so since every time a new partner or beneficiary enters the partnership or bewind trust, on a technical basis, each of the partners or beneficiaries will dispose of a portion of the underlying investments to the new partner or beneficiary, which may cause the realisation of unrealised gains for the other partners or beneficiaries and which may be subject to tax in their hands.

**Carried interest**

Where a fund manager or an affiliate of the fund manager obtains an additional distribution from the applicable fund, there has been an ongoing international debate as to whether such carried interest is subject to capital gains tax or income tax. The debate is currently unresolved.

**Non-South African private equity funds directly investing into South African companies**

In respect of non-residents, South Africa imposes income tax on amounts from a South African source. As discussed above, interest on loans applied in South Africa and dividends on shares in South African companies are deemed to be from a South African source.42 A non-resident fund will accordingly be required to include such interest or dividends in its gross income, but should be entitled to an exemption in respect of the dividends43 (subject to certain exceptions in respect of preference share-type investments and lending arrangements)44 and any interest income should be exempt from income tax in the non-resident fund’s hands, unless the debt from which the interest arises is effectively connected to a permanent establishment of the non-resident fund in South Africa.45 Furthermore, any capital gains will be subject to tax in South Africa if the fund has a permanent establishment in South Africa to which the asset in question is effectively connected.46

Furthermore, the activities of a South African fund manager may result in the gains on the underlying investments being from a South African source. This issue has largely (but not completely) been resolved in terms of the statutory source rules.47

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41 The statutory source rules (see footnote 34), simplistically speaking, provide that gains made in respect of the disposal of an asset (other than immovable property or an interest in immovable property) by a non-resident is only deemed to be from a source in South Africa if it is attributable to a permanent establishment of the non-resident in South Africa. Furthermore, the capital gains tax provisions contained in the Eighth Schedule to the Income Tax Act only apply to non-residents in respect of immovable property or interests in immovable property (which is a defined concept – see Paragraph 2(2) of the Eighth Schedule to the Income Tax Act) situated in South Africa or assets effectively connected with a permanent establishment of the non-resident in South Africa.

42 See footnote 34.

43 See footnote 42.

44 See footnote 29.

45 See footnote 37.

46 See footnote 41.

47 See footnote 55.
In addition, as discussed above, non-resident investors will be subject to dividends tax\(^{48}\) and interest withholding tax\(^{49}\) in respect of dividends on South African shares and interest deemed to be dividends or interest regarded as having been received or accrued from a South African source that is paid to them (subject to certain exemptions and any available treaty relief).

Furthermore, should the fund be managed in South Africa, this may result in the fund being effectively managed in South Africa, in which case the fund may become a South African tax resident with the result that its income and capital gains will be subject to tax in South Africa and distributions may be subject to dividends tax. However, statutory provisions have been introduced in terms of which a foreign investment entity (which is a defined concept) will not be effectively managed in South Africa by reason of having a South African fund manager, meaning that having a South Africa fund manager will not result in a non-resident fund becoming a South African resident provided the requirements of the relevant provisions are met.\(^{50}\) These provisions do not apply to foreign funds where South African investors directly or indirectly hold an interest of at least 10 per cent.

**Exchange control**

South African residents are generally prevented from transferring capital to any country outside the common monetary area (CMA) (consisting of South Africa, Namibia, Lesotho and Swaziland), subject to a number of exceptions. In relation to South African private equity funds wishing to invest outside of South Africa, such investment will generally be made through an institutional investor, utilising its institutional investor allowance. An institutional investor allowance is available to certain institutional investors and fund managers in South Africa, subject to limitations (institutional investors’ foreign exposure of retail assets may not exceed 25 per cent in the case of retirement funds and the underwritten (non-linked) policy business of long-term insurers, and investment managers registered as institutional investors, collective investment scheme management companies and the investment-linked business of long-term insurers are restricted to 35 per cent of the total retail assets under management). Institutional investors may, directly or indirectly, invest an additional 5 per cent of total retail assets in terms of the African allowance.

However, in terms of a recent relaxation, private equity funds that are members of SAVCA, mandated to invest outside the CMA,\(^{51}\) may apply to the Financial Surveillance Department of the South African Reserve Bank for approval to invest offshore (information that must accompany the application includes a copy of the local *en commandite* partnership’s mandate to invest outside the CMA or, in the case of a local fund running parallel with an offshore fund, a copy of the co-investment agreement between the local and foreign partnership, cash flow projections for a 36-month period indicating the amount of capital to be exited from South Africa for investment purposes, and confirmation that the local private equity fund will obtain a minimum of 10 per cent of the voting rights in the respective

\(^{48}\) See footnote 31.

\(^{49}\) See footnote 40.

\(^{50}\) This has been effected in terms of an amendment to the definition of ‘resident’ in the Income Tax Act, which was introduced by the Taxation Laws Amendment Act 22 of 2012 with effect from 1 January 2013.

\(^{51}\) This dispensation previously applied only to South African private equity funds that were mandated to ‘invest into Africa’. However, in terms of the recently updated Currency and Exchanges Manual for Authorised Dealers, this dispensation now allows for global investments outside the CMA.
investment outside the CMA). In the context of a local fund running parallel with an offshore fund where the private equity fund is managed from South Africa, the minimum 10 per cent requirement may be measured on a fund-wide basis, after the conversion of investment rights into voting rights. Applications will also be considered where an unintended loop structure is created as a result of private equity funds investing in companies outside the CMA with a portion of their business in South Africa. In terms of the ‘look through’ principle, any offshore acquisitions by an institutional investor held indirectly via a local private equity fund must be marked off against its respective foreign portfolio investment allowances.

v Offshore structures

For reasons relating to South African tax legislation, South African private equity managers in the past often created parallel offshore structures within which to house investments from non-resident investors, and which offshore funds co-invested with South African-domiciled funds. Mauritius, the Cayman Islands and the British Virgin Islands have in the past often been used as the domicile for these parallel structures. Although recent tax changes to the Income Tax Act have removed some of the previous obstacles, the introduction of new taxes, such as the interest withholding tax, may neutralise or remove the benefits that resulted from the changes. Fund managers and their advisers should carefully consider the potential South African tax implications and applicable double taxation relief prior to taking decisions as to whether a parallel offshore structure is required.

Because of its wide network of double taxation treaties and low tax rates, Mauritius is a popular jurisdiction for the establishment of private equity funds, including funds with South African investors, and funds that will invest in sub-Saharan African countries other than South Africa or countries within the CMA. A new double taxation agreement between South Africa and Mauritius has entered into force on 28 May 2015, which replaced the previous agreement.

It should be noted that certain sovereign fund investors may not invest in funds domiciled in certain jurisdictions.

III REGULATORY DEVELOPMENTS

Private equity funds are not subject to specific regulations, and there is no government agency that exercises regulatory oversight specifically over such funds. There is no requirement that a fund be registered with a government agency. Fund managers are, broadly speaking, required to register as financial services providers under the FAIS. (We understand that the Financial Services Board is considering the creation of a new category of FAIS licence for private equity fund managers.) As mentioned below, fund managers are, from a practical perspective, also required to register as members of SAVCA, the voluntary industry body.

We have discussed the regulatory requirements that apply to the marketing of funds above. Regulatory developments over the past couple of years that deserve mention are the position with respect to black economic empowerment (BEE) and the position with respect to pension fund investors.

i BEE

By way of background, since the election of South Africa’s first democratic government in 1994, the government implemented a comprehensive programme aimed at the transformation of South Africa’s economy in order to address racial and other discrimination of the past.
The Broad-Based Black Economic Empowerment Act 2003 provides the general legislative framework for the promotion of BEE, empowering the Minister of Trade and Industry to issue Codes of Good Practice. The approach under these Codes is to measure the contribution of each South African firm to broad-based BEE in accordance with a detailed prescribed scorecard. An important element of this scorecard involves the percentage of the equity shares of a firm held directly or indirectly by black persons. On a practical level, a firm’s BEE score affects whether it qualifies to participate in regulated industries (such as mining or gaming) and its chances of winning business (including government tenders).

Accordingly, an important consideration in respect of any investment in a portfolio company by a private equity fund is how the investment (together with co-investments) will affect the BEE score of the portfolio company.

In this regard, the Codes of Good Practice published in 2013 (Revised Codes) are designed to give an advantage to private equity fund managers who meet certain requirements, since portfolio companies will be entitled to deem all of the shares held by funds managed by qualifying managers to be held by black persons. Broadly speaking, the qualifying requirements include the following:

\[a\] at least 51 per cent of the fund manager’s voting rights associated with the equity investments in the underlying portfolio companies must be held by black persons;\(^53\)

\[b\] black persons must own 51 per cent of the shares of the fund manager and receive at least 51 per cent of the profits (including carried interest earned by the fund manager or its associate) of the fund manager;\(^54\)

\[c\] 51 per cent of the executive management and senior management of the fund manager must consist of black persons;\(^55\) and

\[d\] the fund manager must invest a prescribed percentage of the value of its funds under management in firms that are at least 25 per cent black-owned. This prescribed percentage is 5 per cent in 2014 and gradually rises to 51 per cent over a period of nine years.\(^56\)

These provisions in the Revised Codes have arguably served as an impetus for the development of more black-owned and controlled private equity fund managers. Note, though, that it should be established, with respect to each portfolio company, whether there are sector-specific BEE charters or licensing conditions that may preclude the application of the provisions in a specific case. For example, the recently published Amended Broadbased Black Economic Empowerment ICT Sector Code slightly amends the above requirements for portfolio companies in the Broadcasting, Electronics, Information Technology and Telecommunications subsectors.\(^57\)

**ii South African pension funds**

The prudential investment limits for pension funds registered under the Pension Funds Act 1956 were amended in 2011 to expressly permit pension funds to invest up to 10 per cent

\[^{52}\] General Notice 1019 of 2013, Gazette No. 36928 of 11 October 2013.

\[^{53}\] P. 22 of the Revised Codes, Paragraph 3.10.1.1. There is debate as to the application of this requirement.

\[^{54}\] Pp. 22–23 of the Revised Codes, Paragraphs 3.10.1.3 and 3.10.3.

\[^{55}\] Id., p. 23, Paragraph 3.10.1.2.

\[^{56}\] Id., pp. 23-24, Paragraphs 3.10.8 – 3.10.13.

\[^{57}\] GN 1387 of 7 November 2016, Paragraph 5.
of their assets in private equity funds (with sub-limits of 2.5 per cent per private equity fund and 5 per cent per fund of funds). In terms of the regulatory framework, the Registrar of Pension Funds published conditions for investment in private equity funds (Conditions) in March 2012 \(^{58}\) that stipulate requirements in order for a private equity fund to qualify for investment by a pension fund. The Conditions came into effect in 2012. Although the applicable requirements do not bind private equity funds, pension funds are significant investors and private equity funds therefore have a strong incentive to comply.

The most significant requirements contained in the Conditions are the following:

a. permissible local private equity structures are limited to en commandite partnerships, bendt trusts and companies;\(^{59}\)

b. fund managers must be members of SAVCA\(^ {60}\) and are required to be authorised as discretionary financial services providers under the FAIS – a category of licence that many fund managers did not hold before the Conditions were published;\(^ {61}\)

c. the auditors of the private equity fund must verify the assets of the fund on a biennial basis,\(^ {62}\) and the fund must produce audited financial statements complying with international financial reporting standards within 120 days of the end of its financial year;\(^ {63}\)

d. the private equity fund must have clear policies and procedures for determining the fair value of the assets of the fund in compliance with the International Private Equity Valuation Guidelines, and any valuations must be verified at least annually by a third party;\(^ {64}\) and

e. the pension fund must consider a list of prescribed due diligence matters before investing in a private equity fund, including the fee structure of the private equity fund and the risk and compliance policies and procedures of the private equity fund.\(^ {65}\)

In our experience, the Conditions have affected the contractual terms of new private equity funds in that pension funds seek warranties from the private equity fund and the fund manager that they will adhere to the requirements set out in the Conditions and wish to see that the contractual terms expressly address the checklist of due diligence matters prescribed by the Registrar. Generally speaking, the regulatory framework has in our view encouraged interest by pension funds in private equity investment. We have also found that pension funds are in their negotiations requiring fund managers to lower fees and carried interest percentages and to accept governance checks and balances to a greater extent than was perhaps the case before the 2008 financial crisis.

\(^{58}\) Conditions for investment in private equity funds; approval in terms of Section 5(2)(e) of the Pension Funds Act 15 March 2012.

\(^{59}\) Condition 2(1).

\(^{60}\) Condition 2(2).

\(^{61}\) Condition 3(1).

\(^{62}\) Condition 6.

\(^{63}\) Condition 9(1).

\(^{64}\) Condition 8.

\(^{65}\) Condition 7.
IV OUTLOOK

We do not anticipate major regulatory or tax changes that will affect the private equity industry in the coming 12 months. Since many funds were established some years ago, increased exits from existing private equity investments as well as increased fundraising activity can be expected. Although South African private equity funds are likely to have increased exposure to sub-Saharan African countries other than South Africa, the current trend is for most South African private equity funds to maintain a primary focus on investment in South Africa. A trend that is likely to continue is the creation of credit opportunity funds with terms very similar to those of private equity funds, but whose investments are primarily in credit assets and whose investment objective is to earn interest and other income.
UNITED ARAB EMIRATES

James Stull, Macky O'Sullivan and Sayf Shuqair

I GENERAL OVERVIEW

Despite the financial downturn and the decline in oil prices that characterised 2016, the UAE has weathered the storm and maintained its position as the centre for private equity in the MENA region. Based on the most recent annual report for the region issued by the MENA Private Equity Association in June 2016, there has been a significant shift in regional investor sentiment with the UAE emerging as the preferred investment destination for the majority of private equity participants interviewed. 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 Egypt.

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. 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 Abu Dhabi Vision 2030.

Broadly consistent with 2015, there has been a continued shift away from previously favored sectors such as the oil and gas sector given the decline and volatility of oil prices. Private equity general partners have been focusing increasingly on key consumer-driven sectors such as healthcare, education, retail and food and beverage with these sectors accounting for the majority of investments by value. There has also been a shift in expectations as far as active investment by sovereign wealth funds is concerned with many expecting more cautious investment by such entities compared to previous years given the decline in petrodollars.

1 James Stull is a partner, Macky O’Sullivan is a senior associate and Sayf Shuqair is an associate at King & Spalding LLP.
Across the region, although investment values decreased marginally, disclosed transactions rose by over 100 from 72 to 175, reflecting growth in investments in both private equity and more markedly in venture capital. 2016 saw the continued rise in venture capital activity in the UAE with two of the five largest venture capital deals in the Middle East in the last six years taking place last year. UAE headquartered e-commerce venture Souq.com completed a fundraising round worth more than US$275 million and Wadi.com operated by Dubai-based Wadi International General Trading LLP raised US$67 million in a Series A fundraising round.

Other fundraising highlights include the announcement in December 2016 by Gulf Capital, one of the largest and most active alternative investment firms in the Middle East, of the successful final close of its second private debt and mezzanine fund, the Gulf Credit Opportunities Fund II, over its target cover of US$250 million. Additionally, Dubai headquartered private equity firm The Abraaj Group, a leading investor in growth markets raised US$526 million for its dedicated Turkey fund, while NBK Capital Partners, a private equity and mezzanine fund manager focused on the Middle East and North Africa, held a first close with US$110 million in capital commitments for the NBK Capital Partners Mezzanine Fund II.

Investors are increasingly less tied to the formal general partner or limited partner structures prevalent in Western markets, thus, announced funds understate the level of raised capital in the industry. Nevertheless, there appears to be a consensus that fundraising is becoming more difficult. Figures show that disclosed fundraising levels declined against the peak experienced in 2014 but remained above levels achieved in 2012 and 2013. Fund managers have had to become more and more creative when it comes to fundraising and there has been an increase in the popularity of the deal-by-deal approach to fundraising. This rise in popularity of the deal-by-deal model may be indicative of the challenges of blind pool fundraising in the MENA region given the political instability in certain parts of the region. This method provides investors with access to direct deal flow and therefore more flexibility. Additionally, the deal-by-deal model offers lower fees than investing via a fund. While this method may be more labour intensive from the perspective of a general partner, the prospect of quicker access to carried interest offer by this method is particularly appealing.

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 with the DFM recording a net profit of US$38 million for the first six months of 2016, 30 per cent lower than the same period in 2015, while the ADX has dropped by 9 per cent over the past year. Although oil prices have recovered from early-2016's multi-year lows, they remain well below the average prices of previous 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 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. It has been announced that two of Abu Dhabi's sovereign wealth funds, the International Petroleum Investment Company (IPIC) and Mubadala Development Company (Mubadala), will be merged, thereby creating an entity with assets worth an estimated US$130 billion, as part of a larger government strategy to diversify the economy and create stronger entities for the growth of the economy. While some cost-saving measures have been put in place and attempts have been made by the government to rein in spending, there has also been investment into other regional asset managers – the recent announcement of the acquisition of a 20 per cent stake by Mubadala Development Company in Bahraini investment manager Investcorp being an example of this.

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. Reliance on the reverse solicitation exemption is common place in terms of private equity fundraising in the UAE. The SCA Board Decision No. 9/RM of 2016 concerning Mutual Funds Regulations came into effect in the last quarter of 2016 formally recognising the promotion of foreign funds on a reverse solicitation basis as an exemption to the requirement for SCA registration. On the other hand in the DIFC, there are no exemptions under DIFC law that allow the marketing or offering of fund interests on a reverse solicitation basis. A unit of a ‘foreign fund’ (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 such 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 such activity. Given the flexibility provided by the reverse solicitation exemption onshore in the UAE, it is common place 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) 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 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 common place 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 such offering be made by private placement only. 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. Exempt funds established in the DIFC may only be offered to a maximum of 100 investors, while qualified investor funds established in the DIFC may only be offered to a maximum of 50 investors. 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.

As far as the fiduciary duties owed by managers to investors is concerned, 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:

a  act honestly;
b  exercise the degree of care and diligence that a reasonable person would exercise if he or she were in the fund manager’s position;
c  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;
d  treat the unitholders who hold interests of the same class equally and unitholders who hold interests of different classes fairly;
e  not improperly make use of information acquired through being the fund manager in order to gain an advantage for itself or another person; or
f  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 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 of a free zone must obtain a licence from the SCA prior to conducting such activities. In the DIFC and the ADGM, the DFSA and the FSRA respectively have regulatory authority over private equity funds.
and their managers in the said 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.

Historically, the UAE has been a tax-free jurisdiction. However, in 2015, in an effort to bolster state revenues, the UAE enacted regulations introducing a value added tax (VAT) that would become effective in January 2018. This has been perceived as a major shift in policy in the UAE, which has long promoted its low or no-tax environment to investors. 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.

There are no taxes imposed in the UAE, DIFC or ADGM in respect of funds domiciled in these jurisdictions. Additionally, there are no withholding taxes payable on payments originating in the UAE to foreign entities.

The UAE signed a tax treaty with the UK on 12 April 2016 that entered into force on 25 December 2016 and took effect (1) with regard to taxes withheld at source, in respect of amounts paid or credited on or after 1 January 2017, and (2) with regard to other taxes, in respect of taxable years (and in the case of UK corporation tax, financial years) beginning on or after 1 January 2017. However, as the UAE does not charge corporate or income tax, stamp duties or withholding taxes, the double taxation treaty may have a limited impact on fund vehicles.

IV OUTLOOK

Despite the challenges posed by geopolitical and global economic factors, stakeholders remain optimistic about the private equity terrain in the UAE. Against a backdrop of a financial downturn and the decline in oil prices that characterised 2016, the UAE has shown its resilience. It has proved that its economy operates outside of the oil and energy sectors, and that it has the infrastructure to maintain and grow its private equity and the wider asset management industry. Regional and international players in the private equity arena see the UAE as the logical regional centre for the private equity industry, with Dubai serving as the hub. In an effort to encourage asset managers to establish a presence and launch investment funds in the DIFC, the DIFC has introduced simpler funds regulations and reduced set-up fees. In Abu Dhabi, the authorities have sought to emulate this success and make the ADGM a competitor to the DIFC. Fundraising is becoming more challenging with negative perceptions, particularly from investors outside the region, of current regional geopolitical factors being a key contributing factor. 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 a viable alternative to blind pool investing.
Chapter 21

UNITED KINGDOM

Richard Watkins and Lisa Cawley

I GENERAL OVERVIEW

In many ways 2015 has built on the successes of 2014. Globally there continues to be a record number of general partners (GPs) raising funds – around 2,530 seeking a combined US$831 billion in commitments, of which 315 are European-focused managers – and the average size of funds raised is at its highest level since 2011, reaching US$564 million, up from US$473 million in 2014. However, 2015 also witnessed a small drop in the aggregate capital raised by private equity funds, from US$555.2 billion in 2014 to US$503.1 billion in 2015, with the number of funds raised also falling by a larger proportion from 1,335 in 2014 to 988 in 2015. The European private equity fundraising landscape has largely mirrored these trends, with European-focused managers accounting for US$70 billion of aggregate capital raised in 2015, down from US$77 billion in 2014 (itself a drop from the US$86 billion raised in 2013).

As was the case in 2014, when record levels of distributions by private equity managers helped to underpin investors’ desire and ability to reinvest in private equity funds, the same is true of 2015 where exit activity and the strong flow of distributions has continued, leading to investors having significant levels of capital to deploy. 2015 saw a record US$523 billion distributed by private equity fund managers to investors – nearly 10 per cent above the previous high of US$477 billion set in 2014. Some private equity firms, most notably the larger, top-performing managers, have benefited from this increased investor liquidity, in particular from the larger private equity investors: Sovereign Wealth Funds, Public Pension Funds and larger Family Offices who, coupled with an increased desire to gain greater control over capital deployment and more favourable economics from top-performing managers, have been writing conspicuously larger cheques.

As the evidence above suggests, investors are on the whole committing larger amounts of capital to a fewer number of managers and generally seeking to consolidate their GP relationships. This market polarisation is increasingly becoming an issue for first-time or less experienced managers and for those that lack a truly differentiated strategy. The bifurcated market of the ‘haves’ and ‘have nots’ that we reported on in 2014 has remained and indeed become more entrenched, in part due to investors reducing the number of GPs they are

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1 Richard Watkins and Lisa Cawley are partners at Kirkland & Ellis International LLP.
2 In this chapter, ‘firm’, ‘manager’ and ‘GP’ are used interchangeably, and could include reference to GPs, advisers, etc.
3 Preqin.
investing in, but also as a result of the macro factors such as high asset prices that we are witnessing across many sectors of the market – private equity buyout firms paid on average a record 10.3x EBITDA multiple for deals in 2015, surpassing even the 9.7x EBITDA multiples last seen in 2007 – leading to lower returns and a tougher marketing story for many managers. In Q3 2015 just 170 managers held a final close, which was a 46 per cent drop from the previous quarter, and the lowest number of final closes held in a quarter for 10 years. While the average private equity fundraising period is currently 16.3 months, the reality is that this focused capital raising environment is leading to top-performing managers raising new funds far quicker than those less well positioned.

Allied to this market polarisation is the ever-increasing variety of product on offer in the market, as evidenced above by the year-on-year increase in the number of managers seeking investor capital. This is leading to an ever more sophisticated investor base, which in turn has resulted in more bespoke and heavily negotiated documentation. As the industry continues to mature we have witnessed a consistent increase in information sharing from GP to investor, and preferential terms for larger investors have become more standard practice, with an increased focus in 2015 on bridging the gross-net spread in a world of anticipated lower returns.

Europe and more specifically the UK, western Europe and Nordic regions have nevertheless seen a host of highly successful fundraisings in 2015. EQT, PAI Partners, Montagu, Exponent, Rhône Group and Equistone Partners all closed their latest funds in 2015 with larger fund sizes than their previous vintages, while Carlyle Europe, Bridgepoint Europe and KKR Europe all closed sizeable funds but at the same or slightly smaller fund sizes than previous vintages.

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 of the UK’s (and EU) VAT, tax and regulatory net). The former strategy would generally utilise an onshore limited partnership, usually an English limited partnership (although Scottish or other jurisdictions may be used). The latter strategy would generally involve the use of an offshore-domiciled limited partnership – generally Guernsey or Jersey – although the former seems to be the favoured jurisdiction for offshore private equity funds, albeit with increasing competition from Jersey. Other

5 Preqin.
6 Preqin.
7 Structures aimed at the retail market, such as VCTs, are not considered herein.
8 See Section III, infra, for more information.
possibilities include Delaware, the Cayman Islands and Bermuda, but these are very much the exception in a UK fundraising, primarily due to time zone, strength of local service providers and investor familiarity.

Some investors have preferences as to the location of the fund (usually due to the regulatory or tax regime that they inhabit), and this may have an impact as to the jurisdiction of the fund or its structure, or both; feeder vehicles or tax ‘blockers’ may need 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 Luxembourg limited partnerships (including the recent SCSp version that is gaining some traction with sponsors who already have a material presence in Luxembourg given its similarities to an English limited partnership), SICARs, SIFs and French FCPRs or offshore companies, although these structures are aimed at specific markets or at specific types or classes of investor and 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 treatment between various funds. While not comprehensive, the main negotiated terms of a private equity fund are as follows.

Target size
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 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 pre-condition (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 it is financed personally, by waiver or some other method) is also very pertinent to prospective investors who want to ensure that they have ‘skin in the game’. The expected number, due to investor pressure, has been steadily increasing and now likely starts at 2 per cent of fund commitments, although there is wide variation.

Closing period
This is the period during which more investors can be admitted to the fund. The ‘market’ position used 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

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10 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’. 
with investor due diligence, etc. Investors have generally accepted this extended period, notwithstanding their concerns that the management team would be distracted from deal sourcing and investment activity by their fundraising efforts.

**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 any risk of failing to invest their funds fully in the allotted period and thereby having to ask for an extension (see earlier), 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**
Often structured as a profit share, 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 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; thus, there has been some downward pressure and heightened scrutiny by investors.

**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 and 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 ‘side-car’ vehicles with a restricted investment mandate for investing alongside the main fund created, in order to cater for these specific investors.

**Investment-related fees**
The receipt of any transaction fees, break-up fees, directors’ fees or monitoring fees is the subject of much debate among investors and managers. In most cases all of these fees would typically be set off against the management fee so that the investors would receive some or all the benefit thereof, and investors have been pushing strongly, and often successfully, for a full set-off in their favour. These types of fees, and critically the full and accurate disclosure

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12 ILPA 2.0, ‘General Partner Fee Income offsets’.
of such fees to investors, are also coming 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 the market position more generally.13

**Preferred return**

There is a surprising lack of movement with the preferred return, notwithstanding today’s low-interest-rate economic environment. Although some funds have created more bespoke arrangements, they are 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 such private equity funds is 20 per cent of the fund profits. There are two main methodologies for calculating such 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 US. As 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, 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).

**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 exposing the investors to the risk of carry overpayment if subsequent drawdowns are not fully returned. Escrow mechanisms are usually utilised, although as US investors have generally relied on clawback mechanisms, the market position has changed, and thus sometimes one or both structures are used, often in response to the nature of the investors’ likely return or drawdown profile and the executives’ attitude to risk (i.e., do 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 fund of funds may be unable to redraw from their own investors and thus push back strongly in this regard.

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**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 last global financial crisis and threatened and actual defaults, these provisions have become more extensive in scope.

**Key man or suspension of investment period**

These provisions have received a lot of investor attention over the past couple of 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 case of any such event 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. With the return of fee and carry discounts, preferential co-invest rights and other special deals in this difficult market, there is a renewed focus on the MFN provision. Managers are seeking to limit applicability by size of commitment, legal status, timing of admission, etc., with investors pushing back in this regard.

**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 14 – 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.

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14 See http://ilpa.org/principles-version-2-0 for ILPA 2.0.
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.15

ii Key items for disclosure

The legislative backdrop now 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.16

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.

Additionally, 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, and thereby minimises the risk of damages claims, recession claims or regulatory sanctions should the fund fail to perform as anticipated. As part of this, the manager will review the offering documents and other related promotions to ensure that all facts and circumstances that will be relevant to a potential investor have been adequately disclosed without material omissions, that all statements of fact are accurate, that statements of opinion are reasonable and are honestly held by those to whom they are attributed, and that all inferences that can be drawn from any of those statements are themselves accurate.

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16 Section 89 of the FSA.
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:

a) the investment highlights, providing a detailed discussion of the investment strategy for the fund and the process by which investments will be made;

b) the track record of the manager or of the relevant executives comprising the management team;

c) the curriculum vitae of the key executives and relevant experience;

d) a market overview, so as to provide investors with a macro view of the investment therein;

e) the summary of key terms (see above);

f) legal and tax matters, describing various regulatory and tax considerations in making an investment in the fund;

g) risk factors, so as to make the investors aware of the risks inherent in an investment in the fund; and

h) 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 that is used for the ‘soft 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, infra).

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, 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 US), and sophisticated placement agents or managers will now generally seek access (via 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

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 was required to be implemented in EU Member States by July 2013, and provided for a period of transitional relief that expired in July 2014. It now 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 and disclosure requirements 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. 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.

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17 Some jurisdictions (notably Austria, France and Italy) have chosen to either 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 European Securities and Markets Authority and the EU lawmakers complete the necessary steps to extend the passport on a voluntary basis to non-EU managers.
The UK has chosen to adopt a relatively straightforward registration procedure under which non-EU managers may commence marketing a fund once a short marketing notification is completed and filed with the UK regulator, the FCA. In carrying on any marketing activities in the UK, non-EU managers are required to continue complying with the UK’s pre-AIFMD national marketing rules, the financial promotions regime. Therefore, non-EU managers 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 of time at which it will need to register the fund for marketing with a local regulator. This in turn will depend on how local regulators interpret the term ‘marketing’ under the AIFMD. In the UK, 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, non-EU managers 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, and 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 regulatory capital, internal governance, systems and controls, remuneration and, significantly, the appointment of a depositary to perform cash monitoring, safe custody, asset verification

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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.
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 which are authorised under the AIFMD are currently not entitled to use a passport to market a non-EU fund in the EU. Rather, onshore managers of such funds are placed on the same footing as non-EU managers in being required to register a non-EU fund for marketing in a particular jurisdiction under national private placement rules.

Onshore managers whose aggregate assets under management fall below the AIFMD’s authorisation threshold, are not required to be authorised under the AIFMD, and are only subject to a limited number of requirements under the AIFMD. They are not entitled to benefit from the marketing or management passport under the AIFMD.

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. The AIFMD contemplates that the EU law makers 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.

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 in turn depends on when ESMA and the EU lawmakers 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 law makers 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

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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.
until it delivered positive advice on a ‘sufficient’ number of non-EU countries. During the course of October 2015, ESMA further clarified that it would publish a second opinion and advice on the extension of the AIFMD passport to a second group of non-EU countries, namely Australia, Canada, Japan, the Cayman Islands, the Isle of Man and Bermuda. ESMA noted that this second opinion would also re-evaluate the suitability of the regimes in the USA, Hong Kong and Singapore for the extension of the passport. The European Commission has asked ESMA to complete this assessment by 30 June 2016.

### ii Tax developments

One of the main fund structuring objectives is to ensure that the investors in the fund suffer no additional taxes as a result of investing through the fund rather than investing directly in the underlying assets. For this reason, private equity funds in the UK are typically established as limited partnerships so that they are viewed as transparent for most UK tax purposes and do not fall into tax and generate tax leakage at the fund entity level.

On the basis that the fund is treated as tax transparent, the characterisation of the receipts of the fund as income (e.g., interest or dividends) or capital (e.g., sale proceeds) should be preserved for UK-resident investors (and some other categories of investors – although this is jurisdiction-specific and on a case-by-case basis). While this means that withholding tax issues can arise without appropriate planning, it historically enabled investors to secure capital treatment for any carried interest (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), such an objective is important for most UK-resident carried interest holders. For those carried interest holders who are UK-resident but domiciled outside of 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, which gives rise to the carried interest.

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 schemes and, accordingly, partnership interests in a carried interest partnership. ‘Employment’ includes any former employment as well an ‘office-holder’ (which extends to include 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). Neither may the ERS rules be relevant if the fund is structured so as to fall within the safe harbour outlined by HM Revenue and Customs and the British Private Equity and Venture Capital Association in a memorandum of understanding relating to the income tax treatment of venture capital and private equity limited partnerships and carried interest (commonly known as the ‘carried interest MoU’).

In addition to the DIMF and IBCI rules described above, further changes have recently been made to the way UK capital gains tax rules are applied to carried interest. From 8 July 2015, ‘base cost shift’ has been abolished and a new minimum level of taxation has been imposed on carried interest. These changes are 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, such that 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 US does not arise. Consequently, it remains critical to ensure that, on first principles, carried interest retains the character of underlying returns in the form of capital gains, and that underlying capital returns are not reclassified as income.

It should also be noted that the UK capital gains tax rate was reduced from 28 per cent to 20 per cent with effect from 6 April 2016, but this reduction does not apply to carried interest, which continues to be taxed at the 28 per cent rate.

From 6 April 2017, individuals who have been resident in the UK for 15 out of the past 20 years, will be deemed to be domiciled in the UK for all tax purposes with the effect that the remittance basis of taxation referred to above will no longer be 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 reassert itself on the individual returning to the UK and becoming UK-resident.
IV OUTLOOK

Top-performing managers, or those first time funds spinning out of successful managers or in-house teams are seemingly very well positioned for the foreseeable future. Investors have significant liquidity with more on the immediate horizon as legacy vintages 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. Nevertheless, as mentioned earlier, there continue to be a substantial number of challenged fundraisings, and those managers unable to sufficiently differentiate themselves by strategy, track record or USP may need to adopt alternative strategies such as deal-by-deal financings, single investor mandates (including managed accounts) or bespoke or particularly investor-friendly economic terms.

The poor performance of certain managers as well as the increased competition for commitments to the top-performing managers has increased traffic in secondary sales or transfers of partnership interests. Recapitalisation and restructuring solutions designed for funds at the end of their life will also become more commonplace as many GPs and their investors seek to address issues raised by either an inability to raise a new traditional private equity fund, or despite several years of record distributions, the legacy issues surrounding the approximately US$800 billion of net asset value that is still captured within 2005 to 2008 vintage funds across the market.21

The AIFMD has now had time to settle into the market, and while some firms still choose to operate outside the AIFMD and the European Union, many are taking advantage of the marketing passport. The burden of tax and further regulatory scrutiny occupies much of a manager’s time, but more crucial than anything else remains the ability of each manager to communicate its USP, navigate the ever increasing volume of market competitors, and position itself to benefit from the trend amongst key investors in the industry to an overall consolidation of GP relationships.

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I GENERAL OVERVIEW

A confluence of factors shaped the US private equity fundraising market in 2016. Consistently high trading multiples and ongoing concerns over the high volume of ‘dry powder’ within the industry were not sufficient to mitigate an influx of fresh capital. Faced with continuing low interest rates and concerns about secular economic growth, institutional investors seeking to satisfy long-term funding obligations had limited options to redeploy a record wave of returning capital. Consequently, these investors were willing to make ever larger allocations to the asset class.

Since the nadir of 2010, when North American-focused funds raised only US$163 billion, fundraising activity recovered to US$312 billion in 2016, significantly outpacing the US$258 billion raised in 2015. Established investors continued to scrutinise management teams and negotiate individual fund terms in particular detail, with fund sponsors marketing their increased transparency and a willingness to accommodate investors’ policies and procedures. In addition, a continued wave of bespoke solutions, such as separately managed accounts, continued to augment the classic approach to private equity fundraising. Over one-third of investors now report the use of special accounts in conjunction with traditional commingled funds. Here, in the current environment, managers are searching further afield for sources of capital, with the result that access to formalised club deals and sizeable co-investments are frequently cited by investors as a prerequisite to new blind-pool commitments, especially with new managers.

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1 Joseph A Smith is a partner, Conrad Axelrod is a special counsel and Christopher S Avellaneda is an associate at Schulte Roth & Zabel LLP. The authors would like to thank David M Cohen and Elie Zolty for their contributions to this chapter.


4 According to industry estimates, an additional 28 per cent (US$188 billion) of private capital was raised worldwide in 2016 for deal-by-deal structures, co-investment and managed accounts: The Triago Quarterly (December 2016), p. 2. See also: Coller Capital, Global Private Equity Barometer, Winter 2015–2016, p. 6; PERE Research & Analytics, ‘Notable Separate Account Commitments,’ 30 September 2014; Preqin Global Private Equity and Venture Capital Report (2017), p. 30 (reporting a 42 per cent participation rate among LPs for co-investments, with 30 per cent participating in separate accounts).
This increased sophistication and attention to detail has come at a cost for both sponsors and investors. As a result of the time and effort involved in conducting pre-commitment due diligence, which may include multiple meetings and on-site visits, investors have tended to increase ticket sizes and concentrate their attention on a finite number of ‘best of breed’ fund sponsors.\(^5\) In some instances, this has led to competition for allocations in the face of scale-backs, rebalancing to a degree the negotiation position of sponsor and investor at the top of the market. This focus on established fund managers has contributed to the ongoing bifurcation of the fundraising market, resulting in a perceived ‘barbell’ distribution of successful fundraises by larger household names and emerging managers with an exceptional track record or value proposition. Commentators have also observed that they expect the steadily increasing proportion of capital raised by ‘mega-funds’ (over US$5 billion) to be offset in part by the declining persistence of top-quartile returns.\(^6\)

New and spin-off managers, however, continued to face particularly high barriers to entry as a result of increased regulatory burdens on marketing and operational activities. These burdens have been exacerbated by lengthier fundraising periods for first-timers, which tend to be less disruptive to established sponsors with dedicated investor relations units.

Larger fund managers, buoyed by the ‘flight to quality’ and their ability to leverage existing institutional relationships and operational infrastructure, have sought to diversify their product palette by offering new investment platforms. These new platforms frequently exhibit investment strategies complementary to the fund manager’s existing vehicles, or further specialised variants thereof, and can be tailored to the individual requirements of larger investors. Unsurprisingly, such structures have been the subject of intense investor and regulatory scrutiny in terms of deal flow allocation and potential conflicts of interest, underscoring the need for fund managers to have in place effective and articulable policies and procedures to alleviate such concerns.\(^7\) Indeed, many believe that the increased regulatory scrutiny since enactment of the Dodd-Frank Act and the focus of the Securities and Exchange Commission (SEC) presence exam initiative on private equity funds (discussed below) has fed investor commentary in this regard.\(^8\)

Notwithstanding these trends, mid-market managers with top-quartile performance continue to receive strong support from an investor base looking to diversify away from ‘mega-funds’.\(^9\) These fund managers are subject to increasing pressure to specialise and differentiate themselves in an effort to demonstrate their unique potential for adding value

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5 The average commitment size of investors in private equity funds has increased 47 per cent in the past five years, to US$50 million. *The Triago Quarterly* (December 2016), p. 2.


8 Note, however, that the SEC’s recent actions are not viewed uniformly among investors: see, e.g., PEI Alternative Insight, PERE CFO and COO Compendium (2015), ‘LPs on the SEC’, pp. 17–19.

9 Three quarters of North American investors have invested in first-time funds since the financial crisis: Coller Capital, Global Private Equity Barometer, Summer 2015, p. 5.
- claims that are increasingly substantiated by market research. New managers entering the industry, as well as established teams spinning off from financial institutions or larger fund platforms, almost inevitably boast of their focus on a niche speciality in order to attract investment capital.

i Market trends

Fund sizes
The largest North American-focused private equity funds raised in 2016 were Advent Global Private Equity VIII (US$13 billion), TPG Partners VII (US$10.5 billion) and Green Equity Investors VII (US$9.6 billion). Buyout funds comprised by far the largest share of 2016 fundraising activity, with 103 buyout funds raising an aggregate of US$120.2 billion (up from 79 funds and US$81.8 billion in 2015).

Types of funds
In general, the fundraising landscape in 2015 has been more favourable for certain types of private equity funds. Although traditional buyout funds appear to have lost some ground, secondary funds are enjoying historic levels of investor appetite and deal flow, while debt funds have grown rapidly to fill the lending gap created by the retreat of banking activity worldwide. Debt funds have become increasingly specialised by sector, tranche and geography, and remain popular among investors with appropriate risk appetites, evidenced by strong increases in mezzanine and distressed private equity fundraising. Infrastructure fundraising surged from US$13 billion in 2015 to nearly US$30 billion in 2016, buoyed by an emerging set of demographic and political trends that foreshadow some relief from the difficulties that have burdened the sector in the past.

Secondary fundraising peaked in 2013, but deal activity remained a vibrant feature of the industry in 2016, reflecting an ongoing desire on the part of both primary and strategic investors to actively manage their private equity portfolios in terms of return profile and liquidity considerations.

Despite mixed success internationally, venture capital funds historically have held a very significant role in the US fundraising market and continue to feature in the allocation priorities of international investors, with a significant proportion of investors in this segment

10 Ibid., p. 5; 91 per cent of first-time fund investments have equalled or outperformed other private equity investments in LP portfolios. See also: Preqin Private Equity Spotlight, December 2016, p. 5; Preqin Special Report, ‘Making the Case for First-Time Funds’, November 2016; Preqin Global Private Equity and Venture Capital Report (2017), p. 52.
12 Between 2009 and 2015, private debt fundraising increased more than threefold to US$96 billion (down to US$74 billion in 2016), with US$49.5 billion raised in 2016 in the US: Preqin 2016 Alternative Assets Fundraising Dataset (January 2017).
being based overseas.\textsuperscript{15} Venture capital fundraising momentum was largely sustained for the sixth consecutive year, with US$34.2 billion raised across 220 funds (2015: US$31.3 billion raised across 175 funds).\textsuperscript{16}

II LEGAL FRAMEWORK FOR FUNDRAISING

i Fund structures

Private equity funds investing in the United States are predominantly structured as limited partnerships, with the jurisdictions of choice being Delaware and the Cayman Islands. The limited partnership statute and specialised corporate judicature of Delaware are widely recognised as providing a flexible and reliable legal framework for private funds. Onshore structures are typically preferred by domestic investors. Foreign investors frequently have tax considerations associated with investing in US-based private funds (including state and federal filing obligations, financial reporting and concerns over ‘effectively connected income’, discussed below) that favour investment through an offshore ‘blocker’ entity, established as either a parallel or feeder vehicle to the main fund.

Fund sponsors generally establish special purpose vehicles to act as investment manager and general partner to the fund vehicles, with a Delaware limited liability company (LLC) or limited partnership being the entities of choice in this respect. The investment manager or adviser entity is commonly used for a series of funds, which can be particularly beneficial in light of the ongoing registration and compliance burdens concomitant with this role (see Section IV.iii, \textit{infra}). This structure permits the sponsor or key executives to maintain control of investment decisions and operational budgets, while segregating incentive payments and investment income between funds and executives on a tax-neutral basis.

ii Fund terms

From a commercial standpoint, very few changes have been witnessed in the headline terms for US funds in recent years, with 2016 being no exception. The consistency in prevalent fund terms is a function of the adverse selection process that permits survival of only the top-quartile fund managers. These preferred managers, aided by the global ‘flight to quality’, are able to negotiate balanced terms on an even footing with experienced investors. Successor funds with a solid investor base have been able to raise funds in recent years with minimal adjustment to prior terms, and the same requests consistently made by investors belie their acceptance of the underlying model. First-time funds with sufficient investor interest are then able to leverage these generally accepted market terms, with some additional concessions.

Two notable exceptions to this stasis are representative of the shift in bargaining positions since the global financial crisis of 2008–2009. A conceptual focus on greater alignment of interests between sponsors and investors has resulted in material changes in the areas of fee offsets and the timing of carried interest distributions:


First, fee offsets have gradually evolved from a historic zero offset, through an intermediate 50 per cent offset, to an 80 per cent and most recently 100 per cent offset. Although 100 per cent offsets can be viewed as excessively generous to investors (since the general partner and its affiliates do not customarily pay management fees themselves, the offset deprives the general partner and its affiliates of their proportionate share of fee income attributable to their own invested capital), they can also be viewed as a result of economic and regulatory pressures in light of recent SEC scrutiny of private equity fee models, discussed below.

Second, distribution waterfalls have migrated slightly towards the European model, with a full return-of-cost waterfall (otherwise known as ‘fund-as-a-whole’) becoming more common, particularly in connection with first-time funds. Interim clawbacks are increasingly used to create a hybrid of both models, as investors seek to mitigate the impact of traditional deal-by-deal distribution waterfalls and thereby further align interests over the life of the fund.

iii Taxation of the fund and its investors

Taxation of the fund

Typically, the fund is organised as a limited partnership or a limited liability company, which is a ‘pass through’ entity for federal tax purposes, and is thus generally not subject to federal income taxes at the fund level. Instead, the income is passed through to its investors and they are taxed on their appropriate share at the investor level.

A partnership may, however, be subject to taxation at the level of the fund (as distinct from any additional federal income tax that is imposed on investors) if the partnership is publicly traded. A publicly traded partnership (PTP) is a foreign or domestic partnership whose interests are ‘traded on an established securities market’ or are ‘readily tradable on a secondary market or the substantial equivalent thereof’. Private equity funds are rarely traded on an established securities market; however, transfers of interests in private equity funds may arguably cause a fund to be deemed to be readily tradable on the ‘substantial equivalent’ of a secondary market. While these concepts are not well defined, US Treasury Regulations provide a number of ‘safe harbours’ that a fund can rely on to avoid PTP status. If the fund falls within a safe harbour, interests in the fund will not be deemed to be readily tradable on a secondary market or the substantial equivalent thereof. Typically, the fund will rely on the ‘limited trading’ safe harbour and the ‘block transfer’ safe harbour. The limited trading safe harbour, often referred to as the 2 per cent safe harbour, applies if the fund does not permit transfers of more than 2 per cent of the total interests in a partnership’s capital or profits in any fiscal year. The block transfer safe harbour allows the fund to disregard transfers of more than 2 per cent of total interests in the partnership’s capital or profits.

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17 The mean offset percentage for buyout funds peaked at 92 per cent for 2012 vintage funds and has since declined to 72 per cent, suggesting some fluctuation in the GP/LP power balance: The 2014 Preqin Private Equity Fund Terms Advisor, p. 42.

18 A number of rules apply for purposes of computing the 2 per cent limit, but their discussion is beyond the scope of this chapter.
Taxation of fund investors

As noted above, most private equity funds are structured so that the fund itself is not subject to tax. Instead, the fund’s income passes through to its investors, who then pay tax on their proportionate share of such income. It is worth noting that private equity funds typically raise a significant proportion of their capital from entities that are US tax-exempt institutions (such as university endowments and pension funds) or non-US entities (such as pension funds or sovereign wealth funds). As a general rule, each of these types of investor is not subject to US tax on its share of income generated by a private equity fund. There are important exceptions to this general rule, which are described below.

Under Section 512(b) of the Internal Revenue Code (the Code), US tax-exempt organisations are exempt from federal income tax on passive income such as interest, dividends and capital gains. Nonetheless, these organisations are subject to federal income tax on their unrelated business taxable income (UBTI). There are two sources of UBTI: income derived from an unrelated trade or business and debt-financed income. The former type of income is typically generated when a fund invests in an operating business that is itself structured as a pass-through for tax purposes. The latter type of income is generated when the fund itself borrows money to make investments. In order to maximise their after-tax return, US tax-exempt investors often require the fund to undertake to minimise UBTI.

In general, non-US investors are exempt from federal income tax on their share of capital gains generated by a private equity fund. Non-US investors that are engaged in a trade or business in the United States are taxed on their income that is ‘effectively connected’ with that business, often referred to as effectively connected income (ECI). Additionally, if a non-US investor has ECI or is a member of a partnership that is engaged in a trade or business in the United States, the investor is required to file a US federal income tax return. Typically, ECI is generated from two sources: income from a business that is itself organised as a pass-through entity, and any gain from the disposition of United States real property interests (USRPI). A USRPI will generally consist of interests in land, buildings and in any US corporation for which 50 per cent or more of the fair market value of its real estate and trade or business assets consists of USRPIs. Non-US investors will also typically wish to maximise their after-tax returns and will do so by requiring the fund to undertake to minimise ECI.

iv FATCA

In addition to the income tax framework described above, the US has enacted the Foreign Account Tax Compliance Act (FATCA), which is a supplementary 30 per cent withholding regime with respect to certain non-US entities, including foreign financial institutions (FFIs) (which term includes most private equity funds and hedge funds organised as non-US entities), and certain persons invested in FFIs. In order to avoid being subject to this 30 per cent withholding tax on certain payments of US-source income such as interest or dividends (withholdable payments), an FFI is generally required to register with the Internal Revenue Service (IRS) in order to receive a US tax identification number. The IRS will then provide that information to the relevant foreign financial institution, which may then be treated as a withholding agent for US-source income. Non-financial foreign entities, unless such non-financial foreign entities comply with certain requirements, including the need to provide certain information about their substantial US owners, if any.

Beginning no earlier than 1 January 2019, the definition of withholdable payment will extend to 30 per cent withholding on the gross proceeds from the sale of US source securities of a type that produce interest or dividends, as well as withholding on certain ‘foreign pass-through payments’, the meaning of which has

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19 FATCA also imposes a 30 per cent withholding tax on certain non-financial foreign entities, unless such non-financial foreign entities comply with certain requirements, including the need to provide certain information about their substantial US owners, if any.

20 Beginning no earlier than 1 January 2019, the definition of withholdable payment will extend to 30 per cent withholding on the gross proceeds from the sale of US source securities of a type that produce interest or dividends, as well as withholding on certain ‘foreign pass-through payments’, the meaning of which has
Service (IRS) and, except as discussed below, enter into an FFI agreement with the IRS. Under such agreement, the FFI must agree, among other things, to perform certain due diligence functions in order to identify its direct US investors (and certain indirect US investors) and to determine the FATCA-compliant status of its non-US entity investors, and to report specific financial information about certain of its investors annually to the IRS. Investors who do not provide an FFI with sufficient information about their US or FATCA-compliant status to satisfy the FFI’s due diligence requirements or who have a non-compliant status generally are subject to 30 per cent withholding on any withholdable payments earned through the FFI or distributed to such investors by the FFI.

To facilitate information reporting under FATCA and minimise the need for FATCA withholding, certain jurisdictions (including the United Kingdom, Ireland, Jersey, Guernsey and the Cayman Islands) have signed intergovernmental agreements with the US (IGAs).21 Pursuant to Model 1 IGAs, an FFI located in an IGA jurisdiction generally is not subject to withholding under FATCA22 as long as it registers with the IRS and complies with the FATCA enabling legislation promulgated by the IGA jurisdiction. While each IGA jurisdiction has enacted, or will enact, enabling rules specific to its own legal system, the due diligence and reporting requirements under these rules are, or are expected to be, substantially similar to the due diligence and reporting requirements provided in the FFI agreement with the IRS. Notably, the requirement to withhold on investors who fail to provide sufficient information about their US status has been suspended. However, the imposition of withholding remains in place for FFI investors who do not have, or certify to, a FATCA-compliant status.

III REGULATORY FRAMEWORK

Private equity funds in the US are regulated principally by federal statutes, although fund entities, if formed in the US, are formed and governed pursuant to state law.

The primary federal statutes, namely, the Securities Act of 1933, as amended (the Securities Act), the Investment Company Act of 1940, as amended (the Investment Company Act), the Investment Advisers Act of 1940, as amended (the Advisers Act), and the Employment Retirement Income Security Act of 1974, as amended (ERISA), are discussed briefly below. The Securities Exchange Act of 1934, as amended (the Exchange Act), and state legislation also play a significant role in the contexts of placement agent activities and governmental pension plans, although a detailed discussion of their application is beyond the scope of this chapter.23

yet to be published by the US Department of the Treasury.

21 For a complete list of countries, see www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.

22 Amounts may still be withheld from payments to such FFIs if that FFI is acting as nominee for the payments on behalf of a beneficial owner that does not certify that it has a FATCA-compliant status.

23 The Exchange Act imposes significant additional restrictions on an issuer with more than US$10 million in assets where 2,000 or more persons hold any class of the issuer’s equity securities (Section 12(g) and Rule 12g-1). General anti-fraud provisions of the Exchange Act nevertheless operate to attach civil liability to material misstatements and omissions of material fact in connection with any offering of securities (Section 10(b) and Rule 10b-5). These obligations, among others, form the basis for the best practice ‘side-by-side’ disclosure of gross and net return figures for private funds in placement memoranda; see also JP Morgan Investment Management, Inc, SEC No-Action Letter (7 May 1996).
Securities Act

The sale of interests in a private equity fund is governed by the Securities Act, which requires securities sold in the US to be registered with the SEC unless an exemption is available. To avoid the burdensome registration and disclosure requirements under the Securities Act, most funds structure their offerings in a manner that qualifies for one or both of the safe harbours promulgated by the SEC. These safe harbours operate within the scope of a general statutory exemption for private placements under Section 4(a)(2) of the Securities Act. Importantly, the Securities Act also applies to any resale of limited partnership interests in the secondary market, so the governing documents of a fund generally restrict the manner in which an investor may transfer its interest.

Regulation D provides an exemption for private offerings of securities to US persons who qualify as ‘accredited investors’, and was amended in 2013 to permit general solicitation (i.e., advertising to the public) in limited circumstances. Issuers relying on Regulation D are required to file Form D with the SEC, providing brief details of the offering within 15 calendar days of the date of first sale, and to update such details on an annual basis in respect of an ongoing offering. In addition, issuers relying on Rule 506 of Regulation D must not be subject to any ‘disqualifying event’ as set forth in the rule. This requirement effectively prohibits private equity funds and their advisers from raising capital using Regulation D if those persons are subject to certain disciplinary events.

Regulation S provides an exemption for certain offers and sales of securities outside the US, whether conducted by foreign or domestic issuers, in recognition of the underlying policy and objectives of the Securities Act to protect US investors. In general, two basic requirements must be met for an offering to qualify under Regulation S: first, the offer or

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24 ‘Accredited investors’ are, generally: regulated entities (such as banks, insurance companies or registered investment companies); natural persons (or spouses) with (joint) net worth of more than US$1 million (excluding the value of any primary residence) or meeting certain income thresholds; corporations, trusts, partnerships and certain employee benefit plans with assets of more than US$5 million; and directors, executive officers or general partners of the issuer selling the securities (see Rule 501 of Regulation D). Securities can be sold to 35 other sophisticated purchasers (who are not accredited investors) without losing the benefit of the Regulation D safe harbour.

25 See further: www.sec.gov/about/forms/formd.pdf.

26 Rule 506 of Regulation D (17 CFR 230.501 et seq.) sets out the requirements with which an issuer must comply in order to benefit from the ‘safe harbour’ assurance that its offering falls within the private offering exemption contained in Section 4(a)(2) of the Securities Act. An offering that fails to satisfy the requirements of Regulation D can nevertheless qualify for exemption under Section 4(a)(2) of the Securities Act, unless general solicitation has taken place pursuant to Rule 506(c) (discussed below).

27 17 C.F.R. Section 230.506(d). The ‘Bad Actor’ rule applies when a ‘covered person’ is subject to a ‘disqualifying event’. The term ‘covered person’ includes both the issuer itself and the investment adviser to the issuer. ‘Disqualifying Events’ include certain criminal convictions, certain court injunctions and restraining orders, certain SEC disciplinary and cease-and-desist orders, final orders of certain state and federal regulators, and suspension or expulsion from any self-regulatory organisation, as well as other events enumerated in the rule.

28 Rules 903 and 904 of Regulation S (17 CFR 230.901 et seq.) establish requirements in order for the issuer and any reseller, respectively, to benefit from the ‘safe harbour’ assurance that its non-US sale or resale is exempted from the registration requirements contained in Section 5 of the Securities Act.
sale must be made in an ‘offshore transaction’; and second, no ‘directed selling efforts’ may be made in the US by the issuer, a distributor, any of their respective affiliates, or any person acting on their behalf in respect of the securities.29

Notwithstanding the latter requirement, contemporaneous domestic and offshore offerings may be undertaken in reliance on both Regulation D and Regulation S.

ii Investment Company Act

An investment fund (as distinct from any manager or adviser thereof) is generally subject to regulation by the SEC as an ‘investment company’ unless an exception from the Investment Company Act applies. Although the term ‘investment company’ broadly encompasses any entity that is engaged primarily in the business of investing, reinvesting or trading in securities,30 in practice private equity funds make use of two key exceptions from this definition.

First, under Section 3(c)(1), an entity that would otherwise qualify as an investment company is exempt from registration if it does not make a public offering of its securities and does not have more than 100 beneficial owners.31 Although this exception is available irrespective of the financial sophistication or wealth of the investors (and permits participation by a potentially unlimited number of ‘knowledgeable employees’),32 compliance with Regulation D (discussed above) will generally require investors to satisfy the ‘accredited investor’ test.

In addition, beneficial ownership is determined on a ‘look-through’ basis for any entity:

- that has been ‘formed for the purpose’ of investing in the fund;
- that holds more than 10 per cent of the outstanding securities of the fund and itself relies on an exception pursuant to Section 3(c)(1) or 3(c)(7); or
- whose investors retain investment discretion in respect of their participation in the entity’s individual investments.

This exception also requires that no public offering of the securities be made in the US, which will normally be the case where an issuer has complied with the requirements of Regulation D or Regulation S to avoid registration under the Securities Act (including offerings employing general solicitation under Rule 506(c)).

29 See further: Rules 902(c) and (h) of Regulation S.
30 Investment Company Act, Section 3(a)(1).
31 The SEC has developed guidance on ‘integration’ (primarily in the form of no-action letters) indicating when parallel offerings will be combined for purposes of calculating the 100 beneficial owner threshold: e.g., side-by-side onshore and offshore offerings to facilitate efficient tax treatment of different classes of investors are typically not subject to integration (Shoreline Fund, LP, SEC No-Action Letter, April 11, 1994). The doctrine extends to integration of offerings under the Securities Act, where the SEC’s five-factor approach has been codified in Rule 502(a) of Regulation D.
32 ‘Knowledgeable employees’ for this purpose are defined in detail by Rule 3c-5(a)(4), and include executive officers, directors and trustees of a company that would be an ‘investment company’ but for the exclusions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, as well as employees who have participated in the investment activities of such company (or substantially similar functions or duties for another company) for at least the preceding 12 months. Issuers must nevertheless take care to observe applicable requirements such as those under tax regulations and the Exchange Act.
Second, a further exception is available under Section 3(c)(7) for an ‘investment company’ if it does not make a public offering of its securities (see above) and the ownership of such securities is limited exclusively to ‘qualified purchasers’, which include:  

- individuals who own at least US$5 million in investments, including joint or communal property;
- family companies with at least US$5 million in investments;
- trusts not formed for the specific purpose of acquiring the securities in question, provided that the trustee or discretionary manager is otherwise a ‘qualified purchaser’;
- companies with at least US$25 million in investments; and
- ‘qualified institutional buyers’.

This exception is favoured by larger funds due to the higher qualification standard and lack of 100-investor limitation. For investors in offshore funds, these qualification criteria apply only to US persons who are admitted into the fund (in keeping with the SEC’s jurisdictional policies focused on protecting domestic investors).

iii Investment Advisers Act

In addition to the private fund itself, the investment adviser or manager of a fund is generally subject to registration and regulation under the Advisers Act, which is intended to address the fiduciary nature of the advisory relationship and focuses on the minimisation or disclosure of conflicts of interest inherent in such a relationship.

Investment advisers with more than US$100 million in regulatory assets under management are eligible for SEC registration, although advisers with less than US$150 million in regulatory assets under management can generally remain subject to state-level regulation.

33 Section 2(a)(51)(A) of the Investment Company Act.
34 ‘Investments’ for this purpose are defined in detail by Rule 2a51-1, and exclude real estate property that serves as an individual’s principal residence for tax purposes (Section 280A of the Code).
35 A ‘qualified institutional buyer’ includes certain types of registered insurance companies, investment companies, investment advisers and employee benefit plans that in the aggregate own and invest on a discretionary basis at least US$100 million in unaffiliated securities.
37 An ‘investment adviser’ is any individual or entity that, ‘for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities’ (Advisers Act, Section 2(a)(11)).
39 An investment adviser’s ‘regulatory assets under management’ is calculated by determining the market value of the securities portfolios to which the adviser provides continuous and regular supervisory or management services, or the fair value of such assets where market value is unavailable (see also Schulte Roth & Zabel LLP, Client Memorandum, ‘Final Rules for the Private Fund Investment Advisers Registration Act of 2010,’ 8 August 2011). The revised definition includes uncalled capital commitments, proprietary and family accounts, accounts managed or advised without compensation, and accounts of clients who are not US persons (see also Breslow, SR & Schwartz, PA, Private Equity Funds: Formation and Operation, Section 10:2).
under similar statutes. No specific qualifications or exams are required to register as an investment adviser, although detailed disclosures are required about the advisory business, services and fees, background of principals, and applicable policies and procedures.

The SEC mandates comprehensive Form ADV disclosures that are accessible to the public, which must be updated by the investment adviser at least annually (or more promptly in the event of certain material changes). Registered advisers are required to provide each client or prospective client with a ‘brochure’ containing all the information in Part 2 of Form ADV before or at the time of entering into an investment advisory contract and, although not strictly required, will frequently provide this information to each investor in the private funds they manage. Investment advisers that manage private fund assets of at least US$150 million are also required to report certain information to the SEC on Form PF, typically on an annual basis within 120 days of the adviser’s fiscal year end.

**Compliance obligations of investment advisers**

In addition to recent regulatory developments discussed further below, registered investment advisers are subject to numerous recordkeeping obligations and requirements to maintain up-to-date policies and procedures reasonably designed to detect and prevent violations of, *inter alia*, the Advisers Act, including a code of ethics and the appointment of a chief compliance officer responsible for administering those policies. An annual review must be undertaken to consider and address compliance matters that arose during the previous year, changes in the adviser’s business, and the effectiveness and comprehensiveness of the adviser’s policies or procedures. The SEC’s Office of Compliance Inspections and Examinations conducts periodic examinations of registered advisers, but may also conduct ‘for cause’ and sweep examinations under appropriate circumstances (see Section IV.i, *infra*).

Specific restrictions also apply to performance-based compensation, which an investment adviser may only charge to sufficiently sophisticated investors, including 3(c)(7) funds (see Section III.ii, *supra*) and qualified clients, as well as non-US persons. Registered advisers are generally required to hold client assets through a qualified custodian (such as a

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40 SEC Regulation of Investment Advisers, note 47.
41 Annual updating amendments are required to be filed within 90 days of the registered adviser’s fiscal year end: Rule 204-1.
42 Rule 204(b)-1 was adopted by the SEC and CFTC in order to assist the Financial Stability Oversight Council (FSOC) in monitoring systemic risk in the US financial system, as mandated by the Dodd-Frank Act.
43 Rule 206(4)-7 does not enumerate specific elements of the required policies and procedures, and the SEC recognises that the application of such policies and procedures may vary widely depending on the size and nature of the advisory business. See also: SEC Release No. IA-2204 (17 December 2003); and Schulte Roth & Zabel, ‘2014 Annual Compliance Checklist for Private Fund Managers,’ www.srz.com/files/upload/private/SRZ_2014_Annual_Compliance_Checklist_Private_Fund_Managers.pdf.
44 Section 205(a) of the Advisers Act restricts the scope of persons from whom investment advisers may receive ‘compensation on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client’.
45 Rule 205-3: A ‘qualified client’ includes an investor that has at least US$1 million under management with the investment adviser, a net worth of at least US$2 million (including joint property but excluding the value of a natural person’s primary residence), qualified purchasers (footnote 38, *supra*), and certain knowledgeable employees of the investment adviser.
bank or registered broker-dealer), but private equity funds holding privately offered securities are eligible for the ‘audit exception’ from such requirements if certain additional conditions are satisfied.46

**Exempt reporting advisers**

Notwithstanding certain registration and reporting requirements, advisers qualifying as either a ‘private fund adviser’ or ‘venture capital adviser’ are exempt from comprehensive regulation under the Advisers Act, but remain subject to the anti-fraud provisions contained in Section 206 of the Advisers Act. These ‘exempt reporting advisers’ are required to file an abridged Form ADV; and may be requested to provide access to books and records in connection with ‘for cause’ examinations. The two exemptions are summarised as follows.

Private fund advisers are investment advisers with less than US$150 million in assets under management in the US and which exclusively advise clients that are private funds (regardless of the size or number of such funds), whereby:

a a ‘private fund’ is an issuer that would be an investment company but for the exceptions provided for in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act;

b ‘assets under management in the US’ includes the gross market value (or fair value, if the market value is unavailable) of those assets attributable to any US place of business, including undrawn capital commitments. Proprietary assets (i.e., any sponsor’s and affiliates’ commitments) may not be excluded for this purpose, but an adviser with its principal office and place of business outside the US may exclude consideration of its non-US clients for this purpose;47 and

c the value of such private fund assets under management in the US must be reviewed annually by the private fund adviser. A private fund adviser whose assets under management in the US equals or exceeds US$150 million has 90 days from the date of its annual update filing to file for registration as an investment adviser with the SEC.48

Venture capital advisers are investment advisers that exclusively advise one or more venture capital funds, regardless of the amount of assets under management. A ‘venture capital fund’ is a ‘private fund’ (see above) that:

a represents to investors that the fund pursues a venture capital strategy;

b does not provide investors with redemption rights;

c holds no more than 20 per cent of the fund’s assets in ‘non-qualifying investments’49 (excluding cash and certain short-term holdings); and

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47 An investment adviser’s ‘principal office and place of business’ is the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control and coordinate the activities of the investment adviser (Rule 203A-3(c)).

48 Rule 203(m)-1(c), SEC Regulation of Investment Advisers, p. 15; footnote 39, supra.

49 ‘Qualifying investment’ means, generally, directly acquired investments in equity securities of private companies (generally, companies that at the time of investment have not made a public offering) and that do not incur leverage or borrow in connection with the venture capital fund investment and distribute proceeds of such borrowing to the fund (i.e., have not been acquired in a leveraged buy-out transaction). SEC Regulation of Investment Advisers, p. 16 (see footnote 39, supra).
d) does not borrow (or otherwise incur leverage amounting to) more than 15 per cent of the fund’s assets, and then only on a short-term basis (i.e., for no more than 120 days).\(^{50}\)

In practice, many foreign advisers with no significant US presence qualify as ‘private fund advisers’ and are required to file with the SEC as exempt reporting advisers, even if their assets under management exceed US$150 million on a worldwide basis.\(^{51}\) Importantly, exempt reporting advisers are not automatically exempted from state registration, so careful analysis is required when maintaining an office, employing personnel or conducting substantial activities in any US state. While relieving non-US fund managers from the most rigorous compliance standards imposed on registered investment advisers, the SEC uses the Form ADV reporting requirements to gather a significant amount of information on the international fund manager community, much of which is publicly available online via the Investment Adviser Registration Depository (IARD). Fund managers that are required to complete SEC filings as exempt reporting advisers should seek local advice on the IARD registration process and aim to complete this well in advance of any necessary filings.\(^{52}\)

**Foreign private advisers**

Although there is no general exemption for non-US advisers, a foreign investment adviser with no place of business in the US and a *de minimis* US investor base may be exempt from registration as a ‘foreign private adviser’ if it:

\(a\) has, in total, fewer than 15 clients in the US and investors in the US in private funds advised by the adviser;

\(b\) has aggregate assets under management attributable to these clients and investors of less than US$25 million; and

\(c\) does not hold itself out generally to the public in the US as an investment adviser, which does not preclude participation by an adviser in a non-public offering conducted pursuant to Regulation D.\(^{53}\)

**Obligations applicable to registered and unregistered advisers**

Regardless of their registration status, investment advisers are subject to statutory and common law fiduciary duties towards their clients, including duties of care and loyalty commonly associated with the underlying agency relationship. Interpreted by courts in tandem with the anti-fraud provisions of the Advisers Act,\(^{54}\) these duties effectively require an investment adviser to act in good faith in its clients’ best interests, in particular with respect to the disclosure of potential conflicts of interest that may result in impartial advice being given to a client.

In addition, the SEC has adopted ‘pay-to-play’ rules prohibiting any investment adviser (whether registered or unregistered) from providing advisory services for compensation to a

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\(^{50}\) Rule 203(l)-1(a).

\(^{51}\) As of 4 January 2016, there were 3,138 exempt reporting advisers registered with the SEC, of which approximately 39 per cent maintained their principal office outside the US (source: SEC FOIA documents).

\(^{52}\) An investment adviser that qualifies as a private fund adviser must file Form ADV within 60 days of relying on the exemption: Rule 204-2.

\(^{53}\) Section 203(b)(3) of the Advisers Act and Rule 202(a)(30)-1 thereunder.

\(^{54}\) Principally contained in Section 206 of the Advisers Act and rules promulgated thereunder.
government client for two years after making certain political contributions. The same rules prohibit remuneration of a placement agent to solicit business from a government entity, unless the placement agent is registered as an investment adviser or broker-dealer (and thus subject to pay-to-play restrictions itself).

iv ERISA
US employee benefit plans continue to represent an important source of capital for private equity funds, with almost US$25 trillion in retirement assets available for investment within this sector (up from US$14.2 trillion just seven years ago).

The Employee Retirement Income Security Act of 1974, as amended (ERISA), and extensive rules and regulations promulgated thereunder by the US Department of Labor govern the obligations of fiduciaries responsible for managing pension plans in private industry. Due to the myriad complexities of ERISA and the potentially significant consequences for a fund treated as ‘plan assets’ under ERISA (including, among other things, heightened fiduciary standards, rules governing the receipt of carried interest and prohibited transaction rules), specialist expertise should always be sought if a private equity fund anticipates accepting commitments from such investors.

In practice, private equity funds generally seek to avoid being classified as holding plan assets by relying on one of the following exemptions, each of which can only be described very generally here.

Significant participation test
If benefit plan investors own less than 25 per cent of each class of equity interests of the fund, then their participation is not deemed to be ‘significant’ for the purposes of the Plan Asset Regulation. Since the passage of the Pension Protection Act of 2006, governmental, church and non-US benefit plans are not counted as ‘benefit plan investors’ for this purpose. One common oversight, however, is that interests held by the fund manager and its affiliates (other than interests held by individual retirement accounts of such affiliates) must be excluded from both the numerator and the denominator for the purposes of this calculation. In addition, the test must be performed not just at each closing but over the duration of the fund. Hence, fund managers must monitor compliance on an ongoing basis, particularly in situations such as investor defaults, transfers of interest, and formation of co-investment or alternative investment vehicles.

55 Rule 206(4)-5; see also SEC Release No. IA-3043 (1 July 2010).
57 In particular, the ‘Plan Asset Regulation’ issued by the US Department of Labor (29 CFR 2510.3-101).
58 A ‘benefit plan investor’ is any of the following: any employee benefit plan (as defined in section 3(3) of ERISA) that is subject to the provisions of title I of ERISA; any plan described in Section 4975(e)(1) of the Code that is subject to the provisions of Section 4975 of the Code; or any entity whose underlying assets include plan assets by reason of an employee benefit plan’s or plan’s investment in the entity: see Section 3(42) of ERISA. An employee benefit plan or pension plan of a US state or local government, a church plan and an employee benefit plan or pension plan of a non-US entity are not ‘benefit plan investors’ under ERISA.
VCOC exception

A private equity fund may qualify as a venture capital operating company (VCOC) if, among other things, it invests at least 50 per cent of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at historical cost, in operating companies as to which it obtains direct contractual management rights ("qualifying investments") and it actually exercises those rights in the ordinary course with respect to at least one of its qualifying investments each year. Once again, there are several formalistic hurdles to obtain and maintain VCOC status. Among other things, the 50 per cent test described above must be met at the time the fund makes its first long-term investment. Hence, if a fund’s first long-term investment is not a ‘qualifying investment’, the fund can never qualify as a VCOC. Because of this strict requirement, if a fund initially qualifies under the significant participation test (discussed above) but contemplates making its first long-term investment before it is closed to new investors, the fund may wish to ensure that its first investment will be a ‘qualifying investment’. Also, although the 50 per cent test for VCOCs implies that not all long-term investments must be qualifying, the 50 per cent test generally must be passed once, annually, during a 90-day valuation period. For the purposes of these rules, ‘operating companies’ are companies that are, either themselves or through majority-owned subsidiaries, actively engaged in the production of goods and services but also include real estate operating companies, which are discussed below. Thus, the VCOC exception is not appropriate for funds-of-funds and most secondaries funds. Notwithstanding that they are so cumbersome, however, the VCOC requirements are generally consistent with the basic business objective of most standard private equity funds: active involvement with the management of underlying portfolio companies in pursuit of value creation on behalf of fund investors.

REOC exception

The real estate operating company (REOC) exception is similar to the VCOC exception and is used by many real estate funds or by the underlying real estate ventures in which a fund that itself qualifies as a VCOC may invest. For a real estate investment to qualify for REOC compliance purposes, the REOC must have rights to participate directly in the management or development of the underlying real property. As an obvious corollary to this principle, the real estate must be actively managed or developed. Accordingly, fallow land and triple-net-leased assets are inappropriate for REOC qualification. As is the case with VCOCs, if a REOC’s first long-term investment is not a qualifying investment, the entity in question can never qualify as a REOC, and 50 per cent of a REOC’s investments, once again measured by historical cost, must be qualifying investments on at least one day during a 90-day annual valuation period. Among other things, a REOC must also actually exercise management rights in the ordinary course with respect to at least one of its qualifying investments in any given year. In sum, although the rules for REOC qualification are also complex and

59 Qualifying investments are either: ‘venture capital investments’ with respect to which the fund has obtained certain management rights permitting the fund ‘to substantially participate in, or substantially influence the conduct of, the management of the operating company’; or ‘derivative investments’ that arose from a prior ‘venture capital investment’: see 29 CFR 2510.3-101(d).

60 There is an exception to this rule for a VCOC that has elected to declare that it is in its distribution period, which is subject to other technical requirements.

61 29 CFR 2510.3-101(e).
nuanced, they are generally consistent with the investment objectives of most value-added, opportunistic and core real estate private equity funds that seek to create value through active involvement in the management of underlying real estate assets.

IV REGULATORY DEVELOPMENTS

i National exam programme and SEC enforcement activity

As a result of the large number of new investment adviser registrations in 2012 following the enactment of the Dodd-Frank Act, the SEC undertook to conduct presence exams of at least 25 per cent of these new registrants. This initiative prompted a resource-intense response that focused not just on demonstrations of formalistic ‘black letter’ compliance, but of practical compliance across the board. In April 2014 the SEC staff presented the initial findings of the presence exam initiative, revealing that over half of such exams had discovered what the SEC believes are ‘violations of law or material weaknesses in controls’.62 Areas of particular concern and ongoing focus for the SEC have centred on conflicts of interest, expense allocations (concomitant with documented policies, verifiable procedures and investor disclosures), hidden fees, and marketing and valuation issues (specifically, track records).63

SEC enforcement actions since 2014 have mirrored the examination programme’s focus on conflicts of interest. In 2015, the SEC’s Division of Enforcement brought several cases against private equity fund managers alleging breach of fiduciary duty because the manager had not disclosed or taken steps to mitigate certain conflicts of interest. Alleged breaches of fiduciary duty underlying SEC enforcement actions have included:

a Broken deal expenses.64 The SEC alleged that a private equity fund manager’s failure to disclose its practice of not allocating ‘broken deal expenses’ to co-investors in fund investments was a breach of fiduciary duty. Most of the co-investors involved were internal firm personnel.

b Expense and fee disclosures.65 The SEC alleged that a private equity fund manager breached its fiduciary duty when the manager did not disclose (i) the manager’s ability to accelerate monitoring fees to be paid in the future prior to the submission of capital commitments by limited partners in the funds and (ii) a discount that it received on legal fees provided to the sponsor but not to the funds.

c Personal investments.66 The SEC alleged that a fund manager breached its fiduciary obligations by failing to disclose that one of the manager’s portfolio managers was a general partner of and had a substantial investment in a company that formed a joint venture with one of the fund’s portfolio companies.

The key takeaway from the cases we have summarised here and the trends in SEC enforcement actions is that the SEC is focusing on failures by private equity fund managers to effectively disclose and mitigate conflicts of interest, and to implement compliance programmes able to detect and mitigate these conflicts of interest.

ii Cases brought against individuals

The SEC is increasingly charging individuals, including both business managers and compliance personnel, with failing to adequately supervise personnel and not establishing compliance programmes reasonably designed to prevent violations of the Advisers Act.

In 2016, the SEC charged a senior analyst of an investment manager with failure to reasonably supervise an employee who procured material non-public information from an insider at a public company, on the basis of which the investment adviser subsequently traded.67 The SEC alleged that the senior analyst in question should have reasonably known to question where his subordinate received the information. The senior analyst was therefore charged with failure to reasonably supervise his subordinate as required by the Advisers Act.

Historically, the SEC generally charged CCOs and other compliance professionals only to the extent they were involved in wrongdoing. However, the SEC recently brought an enforcement action against a CCO for causing his firm’s compliance violations by failing to adopt and implement written compliance policies and procedures reasonably designed to monitor and disclose conflicts related to outside business activities of firm employees.68 In 2015 the SEC also alleged that a CCO aided and abetted violations of the Custody Rule 69 because the CCO was simply ineffective in persuading management to take actions to remedy the investment adviser’s failure to timely distribute audited financial statements to investors.70

The SEC’s recent enforcement actions demonstrate that the SEC is willing to charge individuals personally for failure to supervise subordinates and establish meaningful compliance programmes, but also that individuals do not necessarily need to be directly responsible for wrongdoing in order to be charged by the SEC. Ensuring compliance with applicable law is therefore not solely the responsibility of compliance professionals, but also of business supervisors.

iii Financial CHOICE Act and Dodd-Frank reform

On 10 September 2016, the House Financial Services Committee approved H.R. 5983, the Financial CHOICE Act of 2016.71 The Financial CHOICE Act contains various revisions to the Dodd-Frank Act, and several provisions relevant to private equity fund advisers. As of the date of this writing, the Financial CHOICE Act has been reported to the House of Representatives by the Financial Services Committee, but has not been voted upon.

Two provisions relevant to private equity fund advisers are Sections 450 and 452 of the Financial CHOICE Act. Section 450 of the Financial CHOICE Act exempts advisers to private equity funds from the registration and reporting requirements of Section 203 of the

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68 Investment Advisers Act Release No. 4065 (20 April 2015). Specifically, the CCO was held partially responsible for a portfolio manager and the principals of the firm failing to disclose a conflict of interest to the board of directors of a fund and not disclosing other pertinent compliance matters to the fund’s board.
69 275 CFR 206(4)-2.
Advisers Act. The Financial CHOICE Act also requires the SEC to issue rules that require investment advisers to ‘private equity funds’ (yet to be defined) to maintain records and provide to the SEC reports that the SEC, taking into account fund size, governance, investment strategy, risk and other factors, determines necessary and appropriate.

Even if private equity fund managers are permitted to deregister as investment advisers, the SEC has authority to increase the reporting obligations of exempt reporting advisers if it views such additional reporting as being in the public interest or for the protection of investors. This authority could result in unregistered private equity fund managers shouldering additional reporting responsibilities relative to exempt reporting advisers.

Section 452 of the Financial CHOICE Act expands the definition of an accredited investor to include natural persons who: are currently licensed or registered as a broker or investment adviser by the SEC, the Financial Industry Regulatory Authority (FINRA), an equivalent self-regulatory organisation (SRO) or a state securities regulator; or the SEC determines by regulation have demonstrable education or job experience to qualify as having professional knowledge of a subject related to a particular investment, and whose education or job experience is verified by FINRA or an equivalent SRO. This revision could significantly expand the field of individuals who are able to invest in private equity funds that are not reliant on Section 3(c)(7) of the Company Act.

We have detailed here the provisions of the Financial CHOICE Act that are directly applicable to private equity fund managers, but the Financial CHOICE Act is a comprehensive reform measure and it contains a variety of changes that may, directly or indirectly, affect private equity fund managers. For example, the Financial CHOICE Act as currently drafted would also repeal the Volcker Rule in its entirety.

iv Commodity and futures regulation
The expansion of commodity trading oversight by the CFTC effective at the beginning of 2013 has added another layer of compliance for certain fund sponsors engaging in currency or interest rate hedging activities. The rescission of a central regulatory exemption for private fund advisers (including non-US advisers) effectively limited fund managers to a de minimis exemption for such activities and mandated CFTC registration as a commodity pool operator unless another exemption is available.

72 Section 203(m)(2) of the Advisers Act gives the SEC the authority to require advisers relying on the Private Fund Adviser Exemption ‘to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.’

73 CFTC Rule 4.13(a)(4), which was adopted in 2003, generally exempted from CFTC registration CPOs of funds whose natural person investors are qualified eligible persons (QEPs) within the meaning of CFTC Rule 4.7(a)(2) (a category that includes ‘qualified purchaser’ investors in funds offered pursuant to Section 3(c)(7) of the Investment Company Act) and whose non-natural person investors are either QEPs or ‘accredited investors’ as defined in SEC Regulation D. See also Schulte Roth & Zabel LLP Client Alert, ‘CFTC Staff Issues New FAQ Guidance for CPO, CTA Registration and the De Minimis Exemption’, 24 August 2012.

74 Generally, to qualify for the de minimis exemption for unregistered funds contained in CFTC Rule 4.13(a)(3), either: the aggregate initial margin and premiums on commodity interest positions do not exceed 5 per cent of the liquidation value of the fund’s portfolio (including unrealised gains and losses); or the aggregate notional value of such positions does not exceed 100 per cent of the liquidation value of the fund’s portfolio (including unrealised gains and losses).
IV OUTLOOK

Against the backdrop of a sustained economic recovery in the US and political turbulence in key international markets, the outlook for US private equity fundraising continues to be positive. Fundraising volumes appear well positioned to maintain strength in 2017, although the prospect of higher interest rates and concerns over high trading multiples may continue to relieve upward pressure on private equity allocations. Nonetheless, recent data continue to show that 90 per cent of investors are looking to maintain or increase their allocations to private equity in coming years,75 a situation attributable in part to the record return of capital over the past three years. In this context, we also expect to see continued activity in the emergence of tailored solutions for sophisticated institutional investors, with a renewed focus on the economic flexibility afforded by direct and indirect secondary transactions, co-investments and separately managed accounts. Hence, despite uncertainty regarding certain structural economic conditions, increasing concern about the geopolitical environment and uncertainty over the prospects for regulatory change, the US private equity market, we believe, continues to be fundamentally robust.

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Part II

INVESTING
Chapter 1

AUSTRALIA

John Williamson-Noble, Tim Gordon and Chris Morse

I OVERVIEW

i Deal activity

The Australian private equity market saw significant activity in FY2016.

According to figures published by the Australian Private Equity and Venture Capital Association (AVCAL),\(^2\) private equity investment activity was 2 per cent higher than in FY2015 at A$3.33 billion in FY2016. Average equity investment sizes were higher in FY2016 at A$58 million per investment, compared to A$35 million in FY2015.

In comparison to previous financial years, there were more investments in excess of A$150 million in Australia in FY2016, with six such equity investments, compared to just three in FY2015. International private equity firms continued to make some of the largest deals in FY2016, including Baring Private Equity Asia’s acquisition of SAI Global for A$1.1 billion, which was the largest private equity backed public-to-private transaction to complete in Australia since 2010.

Private equity has also increased its focus on roll-ups to complement cornerstone acquisitions, which are increasingly attractive as more exclusive sale processes (rather than auction processes) are being conducted in Australia. FY2016 highlighted the importance of the ‘expansion/growth’ segment in the Australian private equity landscape. In FY2016, 47 per cent of companies backed by private equity were at the ‘expansion/growth’ capital stage of investment. The total number of ‘rescue/turnaround’ deals also increased by 57 per cent to A$96 million in FY2016.

Private equity divestments decreased in FY2016, with IPO exits and divestments through public markets falling from the levels seen the previous year. According to AVCAL, the total number of companies exited by private equity and venture capital sponsors fell to 42 in FY2016, which was 11 fewer than in FY2015.

In FY2016, private equity exits by way of trade sale accounted for the largest amount divested at cost at A$1.44 billion. This included the sale of Chinese private equity firm Hony Capital’s stake in Santos Limited to ENN Group. Trade sales also accounted for the majority of venture capital exits in FY2016. One of the largest exits was the US$4.4 billion listing of Atlassian on the NASDAQ exchange. Atlassian is a Sydney-based company that received a US$60 million investment from US venture capital firm Accel Partners in 2010.

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1 John Williamson-Noble and Tim Gordon are partners and Chris Morse is a lawyer at Gilbert + Tobin.
FY2014 had seen a record number of exits by private equity sponsors via listings, so, although there were fewer IPO exits in FY2015 and FY2016, the IPO market still provided private equity funds with opportunities to successfully divest large stakes in investee companies. New private equity backed IPOs in FY2016 included Vitaco Holdings (previously backed by Next Capital) and Link Administration Holdings (previously backed by funds advised by Pacific Equity Partners). The end of 2016 also saw the largest private equity backed IPO of the calendar year, Inghams Group Limited, which is discussed below.

In FY2016, the Australian private equity market continued to approach the levels of investment activity seen before the credit crisis. According to AVCAL statistical data recording investments by financial year in Australia, in FY2007, a total of 36 private equity funds invested A$5.84 billion in 106 companies. Comparatively, these figures had dropped in FY2013 to 34 private equity funds investing A$2.7 billion in 67 companies, and again slightly in FY2014 to a total of A$2.1 billion invested by 35 private equity funds in 67 companies. FY2015 saw a significant increase in private equity investment, with a total of 37 private equity funds invested A$3.28 billion in 86 companies. FY2016 saw an increase in total private equity investment of 2 per cent to A$3.33 billion, however the number of companies in which private equity invested fell to 60, a 30 per cent reduction from FY2015. Domestic businesses accounted for 87 per cent of private equity investment by the number of companies and 82 per cent by the investment amount.

Most large foreign private equity firms are present in the Australian market (through their broader presence in Asia Pacific) including KKR, TPG Capital, Bain Capital, Baring Private Equity Asia and the Carlyle Group.

The key sponsors active in the Australian private equity market otherwise remained the traditional players, such as Pacific Equity Partners, Archer Capital, Quadrant Private Equity, CHAMP Private Equity and Crescent Capital Partners.

ii Operation of the market

A share purchase is the most common way of completing an acquisition of a privately owned company or business; however, acquisitions are also commonly structured as asset purchases or share subscriptions. If no regulatory approvals (such as those discussed below) are required, a standard asset or share purchase can be negotiated and completed in a matter of weeks.

Structures for publicly listed company acquisitions include takeovers, members’ scheme of arrangements and shareholder-approved subscriptions for shares. Acquisitions of interests in public companies require significantly greater disclosure and are more strictly regulated than acquisitions of privately owned companies and typically take significantly longer to complete.

The length and complexity of a sale process will also depend on whether the sale requires approval from Australian regulatory bodies, such as the approval of the Treasurer under Australian foreign investment laws and Australian Competition and Consumer Commission (ACCC) clearance. Obtaining these approvals can add months to the timeline of a transaction.

Management equity incentive plans are a common means by which a private equity sponsor incentivises the management team of an investee. They commonly take the form of employee share and option plans under which members of management receive ordinary or preference shares (or options over those shares) or a special class of share, and it is common for any shares or options issued to employees to vest at the time of the private equity sponsor’s
exit (and not before). Some plans do, however, incorporate time and performance vesting before exit. Taxation considerations for participants will usually dictate the specific structure and class of securities issued under an equity incentive plan.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The Corporations Act 2001 (Cth) (the Corporations Act) is the main legislative instrument that governs corporate transactions in respect of privately owned companies. In general, under the Corporations Act, a private equity sponsor will have greater flexibility over its investment structure and the private investee company’s capital structure, and will be subject to significantly less onerous ongoing disclosure requirements.

The Corporations Act and Australian Securities Exchange (ASX) Listing Rules regulate and impose restrictions on corporate transactions involving public companies listed on the ASX.

Where a private equity transaction involves the acquisition of an interest in a public company, and the acquisition of such an interest increases the acquirer's overall interest in the target company to 20 per cent or more, the transaction can only be conducted through certain transaction structures regulated by the Corporations Act and the ASX Listing Rules. The most common types of regulated transactions are takeovers and members’ schemes of arrangement.

Australian foreign investment laws impose prior approval requirements on certain direct and indirect acquisitions of interests in Australian companies and land by foreign persons over a certain value, and also gives the Australian government the power to compel divestments of interests acquired in Australian companies in certain circumstances.

As a general rule, approval from Australia’s Foreign Investment Review Board (FIRB) is required by foreign persons for acquisitions of 20 per cent or more of an Australian business or company with total assets valued at A$252 million or more, and for certain foreign companies that hold Australian assets valued at A$252 million or more. There is effectively a higher threshold of A$1.094 billion for acquisitions outside sensitive industries by US, NZ, South Korean, Japanese, Chilean and, Chinese non-governmental investors. Different thresholds apply for the acquisition of Australian urban, residential and rural land by a foreign person. An entity that is deemed to be a foreign government investor (which could include a private equity fund depending on the nature of the investors in that fund) must notify FIRB before it acquires any direct interest in an Australian entity or business, starts an Australian business, acquires any Australian land or acquires an interest in a mining, production or exploration tenement.

Through FIRB, the Treasurer is empowered to make orders preventing the proposed acquisition by a foreign private equity fund where the proposed acquisition is, in the Treasurer’s view, contrary to Australia’s national interest. In many cases, it is a criminal offence to fail to obtain prior approval for such acquisitions. The Treasurer is also empowered to take certain actions (such as ordering the divestiture of acquired shares or assets) to unwind acquisitions that have been effected without the Treasurer’s approval and where those acquisitions are, in the Treasurer’s view, contrary to Australia’s national interest.

Non-Australian domiciled sponsors will typically structure their fund so as to enable flow-through taxation for investors. This is typically achieved through one of (or a combination of) the following investment vehicles: fixed unit trusts, managed investment trusts (which
is a fixed unit trust with widely held ownership and a substantial portion of the investment management activities carried out in Australia and which, depending on the nature of the interests offered, may be required to be registered with the Australian Securities and Investments Commission), venture capital limited partnerships (VCLPs) or early stage venture capital limited partnerships (ESVCLPs) governed by a limited partnership deed (these funds are typically confined to venture capital and mid-market funds because of the restrictions on the types of investments VCLPs can make). Each investment vehicle has different regulatory obligations (including registration and licensing requirements), tax treatment and may limit the types of investments the fund can make, so selecting the appropriate vehicle for the types of intended investments for the fund is particularly important.

ii Fiduciary duties and liabilities

Under the Corporations Act, shareholders of a company do not owe fiduciary duties to the other shareholders of the company. However, minority shareholders may seek remedies for oppressive conduct by majority shareholders where the majority shareholders use their powers to act in a manner contrary to the interests of members as a whole or their actions are oppressive or unfairly prejudicial to, or unfairly discriminatory against, the minority shareholders. However, such actions are rare.

The key duties that directors of Australian companies owe to the company are:

- to act in good faith in the best interests of the company and for a proper purpose;
- not to improperly use their position to gain an advantage for themselves or cause a detriment to the company;
- to act with care and diligence for the benefit of the company – while there is a defence available where the decision or action is one that satisfies the criteria of being a ‘business judgment’ under the Corporations Act, there are statutory limits on when functions can be delegated and when information or advice from others (including members of the management team) can be relied on; and
- to prevent the company from trading while insolvent.

Under a typical share or business sale agreement, a private equity sponsor selling its interest in an investee company will give warranties in respect of the company and/or business being sold, which may expose the sponsor to warranty claims by the buyer years after the sale. While it is becoming increasingly common in private transactions for a private equity seller to require the buyer to obtain warranty and indemnity insurance in respect of warranties given by the seller under the sale agreement, under the Competition and Consumer Act 2010 (Cth), a private equity sponsor’s fund may be liable for conduct during the sale process that is misleading and deceptive. This statutory liability cannot typically be contracted out of. A private equity fund may also incur statutory liability for misleading and deceptive statements made in a bidder’s statement or scheme documentation when it is attempting to acquire control of a publicly listed company.

Private equity funds will usually try and obtain a ‘clean exit’ when selling their interests in an investee business in order to facilitate the return of the sale proceeds to investors in the relevant funds rather than after warranty or indemnity claim or escrow periods have ended. In addition, private equity sellers will usually be reluctant to give anything more than limited warranties in respect of the business being sold. Accordingly, it is becoming increasingly common in private transactions for the private equity seller to require the buyer to obtain warranty and indemnity insurance in respect of warranties and indemnities given in
relation to the business being sold. The insurance policy allows the buyer to make a warranty claim against the insurer, rather than the private equity fund (which may have distributed all proceeds from the sale and therefore may no longer have any assets to satisfy the claim).

If a private equity sponsor proposes to sell its interests in a publicly listed company, the buyer and the target (being the investee company) will usually enter into a merger or scheme implementation agreement which will normally be entered into between the bidder and target that will govern conduct of the buyer's offer. The target will often provide a 'break fee' and give 'no-shop' and 'no-talk' undertakings under the implementation agreement.

Where a private equity sponsor wishes to realise its investment by way of an IPO of a private company, the Corporations Act and ASX Listing Rules impose strict requirements in respect of the IPO process. The company seeking admission to the ASX will, among other things, need to consider the following issues:

a. the level of ownership and control that a sponsor might be required to retain in the listed entity. In certain circumstances, the ASX will restrict or 'escrow' shares issued before the IPO so that they cannot be sold for a period of up to two years after listing and, in any case, the underwriters will typically require the sponsors to hold a meaningful stake for the forecast period;

b. before a company can be floated on the ASX it must satisfy ASX requirements relating to size or profitability and shareholder spread. It must also ensure that its capital structure and constitution are consistent with the listing rules of the ASX; and

c. the Australian taxation consequences of the listing, including consideration of whether the assets of the company or group being listed predominantly relate to interests in Australian land (in which case Australian capital gains tax and stamp duty may be payable by the sponsor on their exit).

III YEAR IN REVIEW

i Recent deal activity

Private equity investments were spread across a range of sectors in FY2016. According to AVCAL statistics, in FY2016:

a. 30 per cent of private equity investee companies were in the consumer products, services and retail sector, and they accounted for 34 per cent of the total amount invested; and

b. 22 per cent of private equity investee companies were in the healthcare and life sciences sector, and they accounted for 25 per cent of the total amount invested.

Key private equity investments in the consumer products, services and retail sector included Quadrant’s A$400 million acquisition of Fitness First Australia and Pacific Equity Partners’ A$232 million acquisition of Patties Foods. Key private equity investments in the healthcare and life sciences sector included Quadrant’s acquisition of a 50 per cent interest in St Ives Home Care Group from RAC WA, Home Care Holdings’ (a joint venture between Quadrant and RAC WA) acquisition of Injury Treatment, and Affinity Equity Partners’ acquisition of Primary Health Care’s health technology division, Medical Director, for A$155 million.

According to AVCAL, some of the largest deals in private equity were in the financial services sector, which accounted for 25 per cent of the total amount invested by private equity in FY2016. The most significant transaction in this sector was the A$8.2 billion acquisition of GE Capital’s Australian and New Zealand consumer finance business by a consortium of KKR, Deutsche Bank and Varde Partners.
ii Financing

Senior secured debt and mezzanine or subordinated debt are the most common forms of debt funding for private equity acquisitions in Australia. Financing arrangements for private equity acquisitions usually require that the any outstanding liabilities be repaid to the lender on a change of control of the borrowing entity.

The Corporations Act contains financial assistance provisions that restrict a target company from financially assisting someone to acquire its shares (or the shares of its holding company) in the absence of shareholder approval. If the target or its subsidiaries give guarantees or security in favour of a lender who is providing funding to a bidder, this will also fall within the financial assistance regime.

In Australia, the official cash rate has been lowered over the last 18 months. This, together with borrower-friendly conditions in international lending markets, has lowered the cost of acquisition financing for sponsors. Lenders have continued to require sponsors to conduct thorough due diligence on potential acquisitions before agreeing to provide finance, which has lengthened sale processes and has made it harder for private equity funds to make hostile bids for publicly listed companies.

iii Key terms of recent control transactions

In 2016, the largest private equity acquisition in Australia was the acquisition of SAI Global by Baring Private Equity Asia for A$1.1 billion. It was the largest private equity backed public-to-private transaction to complete in Australia since 2010. SAI Global is a leading global provider of risk management products and services, including risk management software, standards, regulatory content, compliance and certification programmes. The transaction was implemented by way of a court-approved members’ scheme of arrangement, and was overwhelmingly supported, with 99.88 per cent of the votes cast by SAI Global shareholders in favour of the transaction.

iv Exits

Although exits through trade sales were the most prominent form of divestment in 2016, there were still notable exits through IPOs. As discussed above, 2016 saw a number of private equity-backed IPOs, including Inghams Group Limited and Global Traffic Network.

As has been the case in the past few years, market sentiment has required private equity investors to retain shareholdings in the investee company post-listing, however, the terms of escrow now commonly permit sponsors to sell down part of their escrowed shareholding if the share price increases for a period after listing. TPG retained a 47 per cent shareholding in Inghams after listing. The escrow arrangements between TPG and Inghams provided that TPG could sell one-third of its shares before 24 December 2016 and its remaining holding by 1 July 2017. It is often the case that private equity investors will sell their shareholding as they exit escrow.

Another significant private equity exit in 2016 was Chicago-based private equity firm, GTCR’s IPO of Global Traffic Network. The IPO was the first Australian exit for GTCR, which held 49 per cent of the newly listed ASX shares. The IPO was priced at A$1.90 per share or a market capitalisation of A$383 million, and saw GTCR sell a 35 per cent shareholding through the IPO.
IV REGULATORY DEVELOPMENTS

The Corporations Act is the main legislative instrument that governs the conduct of private equity sponsors and compliance with the Corporations Act is overseen by ASIC.

Generally, an entity carrying on a ‘financial services’ business in Australia must hold an Australian Financial Services Licence (AFSL), unless an exemption applies. Statutory and common law tests are applied in order to determine whether a financial services business is being carried on in Australia and an entity may be required to hold an AFSL even though it has no physical presence in Australia. AFSLs are issued by ASIC and licence holders are subject to a range of obligations, including in relation to capital adequacy, organisational competence, reporting and holding client assets.

Generally, ‘financial services’ include:

- provision of financial product advice;
- dealing in a financial product; and
- making a market for a financial product.

A ‘financial product’ is broadly defined and includes a facility through which, or through the acquisition of which, a person makes a financial investment, manages financial risk or makes non-cash payments.

There are no specific legal restrictions or conditions imposed on how a private equity firm conducts a sale process for its stake in an investee company, however, as discussed above, depending on the identity of the buyer, the sale may require approval from Australian regulatory bodies, such as the approval of the Treasurer under Australian foreign investment laws or ACCC clearance. Where an IPO is used, there is a high level of disclosure required in order to offer shares in connection with a listing. Misleading or deceptive information in disclosure documents prepared in connection with an IPO attracts significant penalties under the Corporations Act. This statutory liability extends to the individuals and entities involved in the listing or the preparation of the disclosure document (including personal liability for current or proposed directors).

V OUTLOOK

Transaction activity for FY2017 is expected to continue to be strong as a result of an increase in fundraising by Australian private equity funds, as well as interest in Australian assets from overseas private equity firms. Solid Australian business conditions that have arisen as a result of low interest rates and a competitive Australian dollar should also provide support for private equity transaction activity in FY2017. A number of extremely large potential transactions have been mooted by the media.

Private equity transactions within the healthcare and life sciences sector are expected to continue to increase, including more interest in fitness and wellbeing. The acquisition of Fitness First by Quadrant Private Equity in FY2016 is indicative of the growth in this area.
Chapter 2

AUSTRIA

Florian Philipp Cvak and Clemens Philipp Schindler1

I OVERVIEW

i Deal activity

2016 saw some major private equity exits, most notably Swedish private equity firm EQT selling Automic to US-based software house CA Technologies for a reported €600 million, German-based private equity fund Capiton selling Schur Flexibles to US-based private equity fund Lindsay Goldberg for a purchase price reported to be in the range of €300 to €400 million. Both exits followed a broad auction and attracted a lot of interest from strategic investors and financial sponsors alike. The third significant exit was completed by Franklin Templeton and GSO Blackstone-financed Ring International Holding, which sold its coating division to Tokyo-based Kansai Paint for about €570 million after several earlier attempts to divest the coating division in 2014 and 2015 (those discussions involved bidders such as Advent and PIA (Goldman)).

There were also a couple of interesting mid-market, mostly tech-related deals, most notably French private equity fund Ardian buying Austria-based RFID firm Gantner, private equity-backed Scout 24 group buying Austrian-based online properties platform Immodirekt, US-based private equity investor Greenbriar buying Austria-based Frauscher Sensortechnik, UK-based investor group Walstead buying Austria-based Leykam Let's Print and Dubai-based Vis Mundi and Levent Capital buying a significant minority stake in Powerhorse, an Austrian-based energy drink producer (reportedly among the top 15 worldwide size-wise).

In terms of growth capital transactions, the seed capital segment was by far the most active as a result of Vienna establishing itself more and more as one of the major European startup hubs not only for Austrian entrepreneurs but also for entrepreneurs of neighbouring countries. Recently, the opening of the biggest European startup centre was announced, which will be located in a prominent building in Vienna city centre. There were also a couple of noteworthy series A rounds, including a series A investment by Atomico, the VC vehicle of Skype founder Niklas Zennström, Austrian tech fund Speed Invest, Y Combinator and Dawn Capital in Bitmovin, an Austria-based video-streaming platform, and Austria-based private equity fund Cudos Capital’s investment in the Austrian optical tools specialist firm In-vision Digital.

The real estate sector continued to be very active in 2016 in general, but also for private equity, with a lot of deal activity and shareholder activism around major listed real estate companies, which in most cases, however, did not involve private equity funds but rather other real estate investors. Examples of deals involving private equity funds include Lonestar

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buying a portfolio of 31 commercial properties from HETA Asset Resolution AG (the wind-down vehicle of former Hypo Alpe Adria AG), Warburg Henderson buying Vienna speciality shopping centre Gewerbeparkstrasse 13, South African property investor Accelerate Property Fund buying a portfolio of speciality shopping centres (six in Austria and three in Slovakia), Eurazio buying a portfolio of 85 IBIS, Mercure, Novotel and Pullman hotels (including four hotels in Austria), Allianz Real Estate buying a significant minority stake in the Fischapark Wiener Neustadt shopping centre, and Universal-Investment buying student homes and flats in Germany and Vienna.

ii 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 (‘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) 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 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.2 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.3

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 incumbent borrowers), and to grant guarantees and security interests securing the acquisition debt as well as refinanced target company debt (if any). To the extent such guarantees and security interests secure repayment of the acquisition debt, they are of little commercial value, as they are only valid to the extent:

a that the risk of default of the BidCo and the risk of default of the target company (in cases where the security interest is enforced or the guarantee called) are acceptable, and that the granting of the security interest or guarantee will not put the target company

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2 For acquisitions made until 28 February 2014, Austrian tax law provided for goodwill amortisation also 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 typically 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, effective as of 1 January 2016.
at risk considering the risk of default of the BidCo and the likelihood of recovery from the BidCo based on the target company’s recourse claims against the BidCo, where the security interest is enforced or the guarantee is called; and

b the target company receives adequate consideration, which can either be a fee (in which case it should include a margin on top of the fee that would be charged by a bank in a comparable transaction) or an equivalent corporate benefit (e.g., access to financing that would otherwise not be available).

To preserve the validity of guarantees and security interests at least in part and avoid management (and supervisory) board liability, ‘limitation language’ is typically included in the financing documents that limits the obligations of Austrian obligors to an amount and terms that are compliant with Austrian capital maintenance rules.

At the same time, the private equity fund will seek to implement a tax offset structure, which is aimed at offsetting interest expense at the BidCo level with profit generated at the target company level. In principle, there are two methods to achieve this. The first method is to establish a tax group between the BidCo and the target company. In such 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 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 is collapsed prior to the lapse of the three-year period, the group members are retroactively taxed on a standalone 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, an upstream merger of the target company into the BidCo may, however, be feasible. The result of such upstream merger would be that the shares in the target company pass to the BidCo parent, interest expense on the acquisition debt can be offset against profit, and guarantees and security interests granted by the merged entity (holding the cash-generating assets) are not subject to the limitations under the Austrian capital maintenance rules (see above) and thus will be of greater commercial value to the financing banks. In particular, the last point 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 of 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 subsection ii, infra), 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, supra), 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 such opportunity for his or her own
advantage.

A violation of duties of loyalty may result in claims for damages, cease and desist orders
or a challenge of the shareholder vote violating such 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 interests of the company and its
shareholders and not in their own interest;
a duty of confidentiality; and

in the case of members of the management, a duty not to compete. Supervisory board members are not explicitly prohibited from competing with the company, but any competition will always be subject to scrutiny under the duty of loyalty.

Where a member of the management or the supervisory board is at fault, he or she is jointly and severally liable for any damages incurred by the company with all the other members at fault, unless the shareholders’ assembly has approved the measure resulting in the damage. A stock corporation may waive or settle its damage claims with an affirmative shareholder vote of 80 per cent after five years, or even before that with an affirmative vote of all shareholders. A limited liability company may waive or settle damage claims at any time, provided such 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 such proceedings) can bring damage claims on behalf of the company to the extent they cannot recover damages from the company in the following circumstances:

where such claim is based on provisions protecting the proper pay-in of share capital (including liability for unpaid capital contributions of supervisors and liability for an unpermitted return of capital) or because of unpermitted payments made during insolvency (also in cases of slight negligence); and

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 relieve from liability towards creditors (or the administrator).

Other sources of potential liability for the private equity fund involve:

piercing the corporate veil, which is possible in the following circumstances:

- factual management by, or the exercising of control over, the management board by a shareholder (where a shareholder, while not formally appointed, factually manages 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);

liability based on a breach of provisions protecting the proper pay-in of share capital (including liability for unpaid capital contributions of supervisors, liability for unpermitted returns of capital and breach of financial assistance rules); and

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 so long as it is in financial
crisis (in such 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, supra.

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 have slightly gone up in 2016 to around 5x to 6x EBITDA, and relative debt-to-equity ratios of 50 to 70 per cent. Small to mid-cap transactions are sometimes financed through equity only or by domestic banks. 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 mezzanine structures tend to add another layer of complexity that is often not supported by the limited transaction size. On large-cap transactions, separate mezzanine financing (that is, from a separate dedicated mezzanine lender) is sometimes considered, but, given the limited transaction size, is ultimately seldom employed. High-yield instruments are usually only considered for post-completion refinancing, as the time and cost involved tend to be disproportionate to the gains on the pricing side.

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; and
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 pursuant to which it manages its AIFs.

A decision of the FMA regarding the licence must be passed within three months after the applicant has provided all required information. If the AIFM intends to register an AIF as an 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 such an application, the AIFM has to prove that he or she employs a person in a management function 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
The Austrian economy is forecast to grow slightly in 2017. While we continue to see some distress-driven deal activity, we expect this source to dry up over the mid-term. This statement relates to non performing loan transactions in particular, as a considerable part, if not most of the assets required to be sold by HETA Asset Resolution AG (the wind-down vehicle of former Hypo Alpe Adria Bank) have already been divested. Otherwise, the deal pipeline suggests that 2017 will see several secondary and market consolidation transactions, as well as an increasing number of seed and growth capital transactions in one of the successful domestic startups, some of which are already being closely monitored by global
venture capital and tech arms of global generalist funds. In general, the Austrian startup scene has seen a lot of growth over the past three to five years, and has established itself as one of the major European hubs, which should result in a series of interesting targets for tech-focused investors.
Chaper 3

BRAZIL

Marcus Vinicius Bitencourt, Luiz Augusto Osorio and Camila Caetano Cardoso

I OVERVIEW

i Deal activity

In recent years, Brazil’s economic growth has slowed while the country has been suffering a period of political instability. Due to the political and economic crisis, major projects across numerous sectors are being frozen and domestic companies are suffering a credit crunch, which, in some cases, may result in a shutdown.

The Brazilian currency has experienced a smooth appreciation over the last 12 months. However, the previous devaluation of the Brazilian real still reflects the country’s international competitiveness, turning Brazil into an attractive destination for private equity investments.

For that reason 50 per cent of the merger and acquisition transactions held from January to October 2016 were carried out by foreign investors, an increase of 1 per cent compared with 2015.2

Therefore, as a result of the economic and political conjuncture, data from the Brazilian Association of Private Equity & Venture Capital (ABVCAP) and KPMG3 indicates that private equity investment in Brazil during 2015 amounted to US$5.71 billion,4 an increase of 39 per cent compared with 2014.5 The transactions mainly occurred in the infrastructure, health and pharmacy, education and retail sectors, which combined represented 61 per cent of the private equity investments made in 2015.

The same study indicates that, as well as the investments, the amount of divestment transactions in Brazil in 2015 were raised by 23.4 per cent in comparison with 2014. According to data from BM&F Bovespa,6 only one IPO occurred in 2016. The expectation for 2017 is that the number of IPOs will face a substantial increase and that exits through trade sales will be the most common exit strategy during the year.

A broader analysis, including investments and divestments by private equity funds through M&A transactions, shows that these funds participated in 104 transactions from January to October 2016, representing more than 20 per cent of the announced M&A deals

1 Marcus Vinicius Bitencourt is a partner, Luiz Augusto Osorio is a senior associate and Camila Caetano Cardoso is an associate at Campos Mello Advogados.
2 Information from PwC: ‘Fusões e aquisições no Brasil’, October 2016. Available at www.pwc.com.br.
3 ‘Consolidação de Dados da Indústria de Private Equity e Venture Capital no Brasil – 2012/2013/2014’. ABVCAP and KPMG.
4 The monetary values mentioned herein have been converted from reais to US dollars at the exchange rate for 31 December 2016, as published by the Brazilian Central Bank.
5 Variations considering the amounts in reais.
6 Information available at www.bmfbovespa.com.br.
during such period and a decrease of 45 per cent compared with the same period of 2015. Of the M&A deals in Brazil announced from January to October 2016, 57 per cent involved acquisitions of control.

ii Operation of the market

Brazilian practice draws a distinction between the portfolio manager and administrator of investment funds. The activity of both entities, regardless of the level of effort 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 CVM’s rules when investing in Brazil. They are simply classified as foreign investors, and as such are subject to the general rules on registration of capital invested in Brazil issued by the Central Bank. Therefore, since this work already suitably covers other jurisdictions, here we focus 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 an administrator, which must be a financial institution authorised to function by the Central Bank, and a manager. 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 person.

According to data announced by the Brazilian Association of Financial and Capital Market Entities (ANBIMA), in November 2016 the largest private equity fund managers in Brazil in terms of net assets were Credit Suisse, Itaú Unibanco SA, BB DTVM SA, Bradesco and BTG Pactual.

The CVM’s rules basically allow the administrator and manager to obtain remuneration in two ways, through administration and performance fees, 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 the investment, as a percentage of the gain, calculated according to a criterion defined 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 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 are generally around 20 per cent of the profit generated above a benchmark rate of return set in the fund’s by-laws (according to a study of 27 funds formed between 31 December 2009 and 31 March 2010). These fees are paid at the time of redeeming the investment, after adjusting for inflation.

In many cases, the fund names a representative to hold an executive position with the most important investee companies. In this situation, the person in question can receive a stock option plan or other incentive, with the cost in the final analysis passed through to the fund’s investors in proportion to the holding in the company in question.

7 Information from PwC: ‘Fusões e aquisições no Brasil’, October 2016. Available at www.pwc.com.br.
8 CVM Instruction 558/15, in force since January 4, 2016, rules the activities related to the securities portfolio administration.
10 Information from a report of ABVCAP in partnership with Insper.
With respect to the purchase or sale of an equity stake, the standard procedure includes the following steps:

- negotiation of the terms of the deal, with the signing of an MoU or term sheet;
- carrying out of a due diligence process by the potential buyer. Tax and labour issues are usually the most sensitive concerns;
- negotiation of the definitive documents, including the share purchase agreement and shareholder agreement (as the case may be);
- signing;
- submission to the Administrative Council for Economic Defense (CADE) if the deal is subject to antitrust notification; and
- closing.

This process can vary according to the complexity and other particularities. The average time between the term sheet and closing is around four months if the deal is not subject to approval by CADE. The rules of CADE are broad enough to cover a good part of private equity transactions. In such cases, the acquisition documents are signed under condition and the closing can only occur after CADE’s approval.

Another common way to sell a corporate stake when there are various interested parties is by competitive bidding. In this case, the negotiation starts with several interested parties, who analyse the preliminary data on the company and submit proposals. Those with values below the expectation of the sellers are eliminated from the running, after which only the prospective buyers with the highest valuations continue the negotiation process, until a final buyer is identified.

II  LEGAL FRAMEWORK

i  Acquisition of control and minority interests

Private equity funds domiciled in Brazil are set up in the form of equity investment funds (FIPs) and are subject to the regulations of the CVM. 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 rules of the CVM, they must submit all their relevant documents, such as balance sheets and portfolio composition, as well as report any intention to issue new shares of the fund, replace the administrator or amend the by-laws, and of any pending spin-off, merger, consolidation or liquidation.

The rules on FIPs historically require their active participation in the decision process of the portfolio companies, with 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

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11 CVM Instruction 578, mentioned below.
following ways: by holding shares in the controlling block; through a shareholder or voting agreement; or by any other agreement that assures the fund effective influence. The investee companies also must satisfy certain corporate governance requirements. 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 assure, on a permanent basis, the majority of the votes in the decisions of the general meeting and the power to elect the majority of the administrators (directors and officers). Participation in the controlling block is defined as being a party to a shareholder or voting agreement that guarantees influence in the decisions of the company.

Nevertheless, according to the CVM Instruction 578 of 30 August 2016 (CVM Instruction 578), 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 rate below 15 per cent of the company’s corporate capital; or the book value of the investment is reduced to zero.

Foreign private equity funds can set up an FIP in Brazil as a vehicle to make investments. As for any other foreign investment, the capital must be registered with and follow the rules of the Brazilian Central Bank. 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 is currently taxed at zero per cent, provided that the following requirements are met:

\[ a \] the non-resident investor 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 (shareholding test) or does not have the right to receive 40 per cent or more of the total income generated by the fund (economic test);

\[ b \] the non-resident investor 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 (shareholding test) or does not have the right to receive 40 per cent or more of the total income generated by the fund (economic test);

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12 Namely: they may not issue founders’ shares or have any such 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, shareholder 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 undertake to the fund to adhere to a trading segment of an exchange or organised over-the-counter market that requires enhanced corporate governance, as per the preceding items; and their annual financial statements must be audited by an independent auditor registered with the CVM.

13 This is generally preferred over incorporating a local company, because of the greater bureaucracy for opening (and more so for winding up) companies in relation to investment funds.

14 Resolution 4,373 of 29 September 2014, from the National Monetary Council.

15 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 4,373/12. 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 such list as being a numerus clausus list, namely, any jurisdiction not appearing on the list will not be deemed as a favourable tax jurisdiction. Ireland was the last inclusion in the end of 2016.

16 Such 40 per cent ceiling considers the following related parties of the investor of the FIP: (a) Regarding individuals, (1) its relatives up to the second degree, (2) company controlled by the investor or by any of its
\[ b \] the fund does not have in its portfolio, at any time, debt securities in an amount exceeding 5 per cent of its net worth, except if such securities correspond to convertible debentures, subscription warrants or public bonds;
\[ c \] at least 67 per cent of the portfolio of the fund is composed of shares of corporations, debentures that are convertible into shares and subscription warrants (allowed assets); and
\[ d \] the fund is compliant with additional portfolio requirements provided by CVM regulations, which currently require that at least 90 per cent of the portfolio of the FIP comprise allowed assets.

Additionally, 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):
\[ a \] the quotaholders 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 such assets are residents or are domiciled outside Brazil (except if situated in a favourable tax jurisdiction); or
- assets traded in financial and capital markets that are exempt from taxation, provided that they are negotiated by the funds under the same terms and conditions set forth 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, due to its regulatory purpose rather than budgetary, 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 4,131/62. A foreign direct investment can occur by incorporating a new company or investing in an existing one (limited liability company relatives up to the second degree and (3) partners or managers of the company controlled by the investor or its relatives up to the second degree; and (b) regarding legal entities, the one that is its controller, controlled or affiliated.

\[ 17 \] If the fund regulations restrict its quotaholders 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 11,033/2004 (e.g., certificates of real estate receivables (CRIs), real estate investment funds (FIls)).
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 shareholder 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.

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, CVM rules or the FIP’s by-laws. The CVM has also issued specific rules for portfolio managers of funds,\(^{18}\) and any infractions subject them to penalties if they are found guilty in an administrative sanction proceeding conducted by the CVM.

Complementary to the CVM’s rules, ABVCAP and ANBIMA have issued the ‘ABVCAP | ANBIMA Code for Regulation and Best Practices for the FIP Market’ with the aim of raising fiduciary standards and promoting best practices, 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 that engage in administration and portfolio management activities.

Representatives of the manager named as directors, officers or to 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 as all active and honest people employ 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 caused in exercising their voting right.

III YEAR IN REVIEW

i Recent deal activity

Despite the current scenario of economic and political instability, important private equity deals were carried out during 2016. In September 2016, the Canadian fund Brookfield acquired 90 per cent of stake of a transporting company, Nova Transportadora do Sudeste, a gas pipeline of Petrobras Group, for approximately US$5.19 billion. In November 2016, Brookfield acquired a stake of 70 per cent in Odebrecht Ambiental, a private operator in the sector of basic sanitation, for approximately US$800 million.

Among other relevant transactions carried out in 2016, Black River, an American private equity firm acquired two sugarcane plants in the state of São Paulo, from Ruette Group,

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\(^{18}\) CVM Instruction 558/15, in force since 4 January 2016, sets forth the conduct rules that administrators and portfolio managers are subject to in the performance of their duties.
for approximately US$255 million and Wirecard, a German provider of financial services, acquired a 100 per cent stake in Moip, an online payment platform, for approximately €37 million.

ii Financing

The scenario for financing of private equity changed substantially in 2016, due to the issuance of CVM Instruction 578, which consolidated previous amendments to the provisions that rule the structure and guidelines for FIPs and the current active funds must comply with the new standards within 12 months as of the date of publication of CVM Instruction 578. Under the new rules, FIPs are now able to invest on limited liability companies and in non-convertible debentures, expanding the investment strategies and types of assets suitable for FIPs, and also facilitating the investment in start-ups and early stage companies.

Furthermore, FIPs are now permitted to invest up to 20 per cent of their net equity in offshore private equity assets. A special type of FIP, offered exclusively to professional investors, has been created to invest up to 100 per cent of their net equity abroad. It is allowed to have authorised capital, which means that the administrator may issue new quotas in FIPs, without requiring investor approval. The administrator may create different classes of quotas that 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 members of committees.

In order to harmonise the Brazilian accounting principles with international standards, FIPs qualified as investment entities shall mark the portfolio assets according to their fair value, while FIPs that do not qualify as investment entities shall 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 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.

In cases where a particular shareholder has great importance in the development of the company’s business plan, a lock-up clause can be used, by means of which this shareholder cannot sell the respective shares during a certain period, to assure that the transition to management by the new controllers will occur as smoothly as possible.

19 Previously, according to CVM Instruction 391, FIPs could only invest in corporations and not in limited liability companies. Additionally, FIPs could not invest in non-convertible debentures, but only in the convertible ones.
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.20

iv Exits
As previously explained, divestment via an IPO and follow-on sale of shares was the exit strategy most often used in the Brazilian market in 2011 and 2012. One example is BR Investimentos’ investment in Abril Educação, a publisher. In July 2010, BR Investimentos, through its funds BR Educacional FIP and FIP Brasil de Governança Corporativa, invested about US$98.18 million to acquire a 24.7 per cent stake in Abril Educação. In July 2011, one year after the capitalisation of BR Investimentos and after various acquisitions, Abril Educação held an IPO on the BM&F Bovespa, and in April 2013, a follow-on offering in which the funds of BR Investimentos sold approximately 45 per cent of their interests. The funds remained with a combined stake of about 8.5 per cent in the company.21

Despite the poor outcome of 2016 the market is more optimistic for 2017, as banks predict that around 20 IPOs will be carried out, in contrast with just one during 2016. However, as already mentioned, as a result of the current economic and political scenario, a reasonable recovery in capital market activity is expected to take place on a lengthy period of time. In view of the current macroeconomic adjustments that Brazil has been experiencing, analysts expect that capital market investors will stand still for at least the next months.

At the time of writing, M&A private transactions are predicted to be the most important exit strategies this year.

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 to this, many sectors of the Brazilian economy are subject to the specific oversight of regulatory agencies. There are currently 10 such agencies, all established between December 1996 and September 2001: the National Telecommunications Agency; the National Petroleum, Natural Gas and Biofuels Agency; the National Electric Energy Agency; the National Supplementary Health Agency; the National Sanitary Surveillance Agency; the National Sanitary Surveillance Agency; the

20 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 the BM&F Bovespa (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.

National Water Resources Agency; the National Cinema Agency; the National Waterway Transport Agency; the National Land Transport Agency; and the National Civil Aviation Agency.

Some of these agencies regulate M&A transactions, enforcing respective technical, legal and financial requirements to be observed by the parties involved, and must also be consulted before concluding changes of control, meaning that their approval must be obtained before closing a deal. In such cases, both the regulatory agency and CADE have the power to block transactions.

V OUTLOOK

The private equity industry in Brazil has been growing strongly in recent years, and there is great demand for investments in various sectors of the economy, especially in Brazil’s infrastructure, and in the petroleum and hospitality sectors.

The environment for private equity investments has also been 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.

Some important challenges to investments in the country need to be overcome, 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 making investments in Brazil.
Chapter 4

CANADA

*Michael P Whitcombe and Charles Chevrette*

I OVERVIEW

i Deal activity

Unless otherwise indicated, data sourced from S&P Capital IQ and the Canadian Venture Capital & Private Equity Association (CVCA).

Canada remains highly ranked by a number of sources as an attractive country for foreign financial players to invest in, particularly US investors. Investments in Canadian corporations by non-Canadian financial buyers rose sharply to 41 per cent of overall deals in 2016. Canada has competitive corporate tax rates, established public markets, an educated and diverse labour force and a need for significant infrastructure investment. The legal system is fully developed and similar, in many respects, to the American system. Those factors, coupled with the declined value of the 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 of Canada, has resulted in Canada being a net exporter of investment capital.

While there have been a few very large Canadian private equity transactions in the past year exceeding C$1.5 billion, most Canadian transactions are in the C$15–100 million range.

On the buy-side, approximately 40 per cent of 2016 M&A deals involved a financial investor while on the sell side, financial investors took advantage of the seller-friendly market conditions including strong valuations to exit their investments.

In 2016, despite growing mid-market activities, the total private equity investment in Canada dipped by 40 per cent from $22.9 billion in 2015 (over 424 deals) to $13.7 billion (over 536 deals).

On the positive side, the number of deals in the Canadian mid-market sweet spot (C$20–C$50 million deal size range) increased by 41 per cent from C$1 billion invested (over 34 deals) in 2015 to C$1.5 billion in 2016 over 43 deals.

There were about 32 deals over C$50 million amounting to C$11 billion with the C$1.6 billion acquisition of Toronto-based Trader Corporation taking the top spot.

Oil and gas companies got C$4.4 billion (32 per cent) of the funds invested, down 49 per cent from 2015 but still is the sector that attracts the most private equity investments

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in Canada. Clean tech saw a 200 per cent uptick in investment with almost C$2 billion invested in over 25 deals while ICT companies received C$2.5 billion (over 65 deals), up 352 per cent from the C$556 million in 2015 (over 59 deals).

**Trade sale**

M&A continued to be the primary exit vehicle for PE firms in 2016 with 49 exits totalling C$6.5 billion, down 44 per cent from C$11.5 billion in the previous year.

**Secondary sale**

The CVCA reported 17 exits by way of secondary sales by private equity investors in 2015 representing approximately C$3.8 billion. For the first three quarters of 2016, only six secondary sales by private equity investors were reported.

**IPO**

According to the CVCA, in 2015, the IPO market for private equity remained slow representing only C$2.5 billion over four deals in 2015.

In 2016, the IPO activity for private equity-backed companies has been near non-existent.

In 2016, overall, both the number and value of Canadian buyout transactions involving a financial investor declined in 2016 according to S&P Capital IQ. This is the third year of a downward trend from the high point in financial investor M&A activity in 2013. A contraction of 24 per cent in deal value and a 19 per cent drop in the number of deals are reported for 2016.

Canada had a C$42.2 billion record year in 2014. However, this figure was skewed by the 2014 *Tim Hortons/Burger King* deal that alone represented C$11.8 billion.

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 2016 are from Quebec: Investissement Québec, Caisse de dépôt et placement du Québec and Fonds de solidarité des travailleurs du Québec (FTQ).

There are hundreds of US private equity funds investing in Canada in any given year, including some of the largest US funds.

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

**Operation of the market**

Stock options remain the most popular stock-based compensation tool, due to their favourable treatment (no taxation until exercise and general eligibility for a capital-gains equivalent rate of tax). Other popular stock-based compensation arrangements for management include stock appreciation rights, and deferred stock units.

Sellers of businesses will, on occasion, take back equity in a corporate purchaser. The precise terms of the equity interests offered to, or required of, continuing management are often a major point of negotiation in transactions. Typical structures include multiple classes
of equity with one class designed to pay out investors, such as the fund and any co-investors, in priority over a second class designed to pay out continuing management only if the business is eventually sold for more than a certain threshold value.

A number of considerations drive these equity structures including the negotiating power of the management team and their personal tax considerations, as well as the openness of the private equity fund to use structures other than their typical or preferred structure.

In order to align interests, most stock option plans call for options to vest and become exercisable upon the achievement of certain conditions. Those conditions are typically tied to either continued employment and the passage of time, or certain performance or success requirements, such as the achievement of stated financial returns.

Generally, management equity is structured to allow for repurchase by the company upon a termination of employment at a repurchase price based on whether the termination was a ‘good exit’ or a ‘bad exit’. Most of the time, the options granted to management typically vest automatically in the event of a sale of the company by the private equity investor.

Privately held Canadian businesses are generally acquired by private equity buyers either through a purchase of assets or a purchase of shares. Private equity investors will typically incorporate a Canadian acquisition corporation. This acquisition entity then acquires all of the shares or assets of the Canadian target and, in the case of a share acquisition, the acquisition corporation and target are often ‘amalgamated’ under the relevant corporate statute.

Whether a Canadian acquisition should be completed by purchasing assets or shares is driven by tax and non-tax considerations. The weight given to these factors will depend on the circumstances of the transaction and the parties’ ability to leverage their respective positions. From the point of view of a potential acquiror, the greatest benefits of an asset sale are tax advantages and the ability to pick and choose the assets and liabilities that will be acquired. However, asset sales tend to be significantly more complex in larger transactions and can require consent from numerous third parties. In contrast, a share sale is usually simpler from a conveyancing perspective. From the seller’s perspective, tax considerations generally favour share transactions as individual sellers may be able to utilise their personal capital gains exemptions to shelter a portion of the proceeds. 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 auction. 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 that adequate arrangements (an interpreted statement) must 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. Due to this flexibility, most Canadian privatisation transactions involving private equity investors are completed by a plan of arrangement.

In friendly acquisitions, break fees are often seen in connection with ‘no-shop’ provisions. The ‘no-shop clause’ is typically subject to a fiduciary out.

Canadian publicly traded companies are also regulated under provincial and territorial (not federal) securities laws which regulate, among other things, public securities offerings,
continuous disclosure, insider trading and tender offer transactions. In addition, there are two principal stock exchanges in Canada, the Toronto Stock Exchange (TSX) (senior market) and the TSX Venture Exchange (junior market), which also regulate Canadian public companies.

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 firms utilise their equity positions, or negotiated minority rights, to assign seats on the board of directors to their principals and nominees. As such, they typically have the authority to run the portfolio company for the period of their investment. In Canada, the names and addresses of private companies’ boards of directors are publicly available information. However, the names of shareholders of private companies are not publicly available, except in certain jurisdictions like Quebec where the names of the three largest shareholders are publicly available.

The default dissent rights provided under corporate legislations are typically supplemented through unanimous shareholder agreements that ensure the private equity investor has ultimate control over the portfolio company. Often, such veto rights cease to apply where a private equity investor’s equity interest is reduced below a given benchmark.

Where a private equity investor holds a minority position, veto rights are still typically enjoyed over critical business matters such as acquisitions, changes to the board and management team, changes to constating documents, the issuance of new equity or debt and the disposition of key assets.

In order for a shareholder agreement that sets forth 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, it must be unanimous in nature (signed by all shareholders) (USA). At the director level, only certain director discretion can be fettered by a USA and most notably, the fiduciary duty directors of portfolio companies owe to the company cannot be restrained or waived.

Private equity investors taking minority positions, once only common in smaller growth equity deals but now an increasingly popular trend in larger transactions, require private equity firms to consider different structuring issues due to the lack of control. The minority rights stipulated in the shareholders agreement become of primary concern to ensure private equity firms have veto power (or at least significant influence) over critical decisions. Likewise, put and drag-along provisions are key to ensure the private equity investor has flexibility with regards to its exit strategy. A minority interest may also be taken in the form of a convertible debt instrument.

A shareholder agreement that is not signed by all of the shareholders of a company is treated as a regular commercial contract. It is subject to the articles and by-laws of the corporation and the provisions of the relevant corporate statute.
To the extent a USA restricts the powers of directors to manage the business and affairs of the corporation, shareholders who are given that power inherit the rights, powers, duties and liabilities of a director under corporate statutes or otherwise.

Canadian courts will not enforce restrictive covenants that unnecessarily restrict an individual’s freedom to earn a livelihood. What is reasonably necessary depends on the nature of the business, its geographic reach, and the individual’s former role in that business. Canadian courts will not enforce a restrictive covenant that does not contain any time limit. 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 such 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**

Management and administration fees paid by a Canadian resident to an arm’s-length non-resident for services provided by the non-resident in the ordinary course of the non-resident’s services business are not subject to Canadian withholding tax. A 25 per cent withholding tax can apply when these conditions are not met, although exemptions are available under most of Canada’s treaties (including the US Treaty) provided the treaty country resident does not render the subject 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 one-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**

The Organization for Economic Cooperation and Development’s recently completed the Base Erosion and Profit Shifting (BEPS) initiative, insofar as anti treaty-shopping measures are concerned, may have a significant impact on foreign-based private equity funds’ usage of intermediary entities in favourable jurisdictions (such as Luxembourg and Netherlands) for their Canadian investments.

**ii Fiduciary duties and liabilities**

In contrast to some American jurisdictions, controlling shareholders in Canada do not owe a fiduciary duty to minority shareholders. However, like most Commonwealth jurisdictions, the corporate laws in Canada generally provide for an oppression remedy, being 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 which unfairly disregards that complainant’s individual interests.

Directors of a corporation who are nominees of a particular shareholder are subject to fiduciary duties to act in the best interest of the corporation, not the shareholder who nominated them.

In Canada, all directors owe fiduciary duties to the corporation, including a duty to act in the best interest of the corporation. The potential statutory liabilities directors are exposed to can be extensive and the basis for this potential liability varies. Directors may be personally liable for their own wrongdoing or failure, such as breaching the duties of loyalty and of care, or, in other instances, held personally liable for wrongdoing by the corporation. The statutes that impose director liability include those governing corporate matters, securities compliance, employment and labour protection, taxation, pensions, and bankruptcy and insolvency.

Canadian corporate statutes require directors to disclose in writing the nature and extent of their interest in a proposed material contract or transaction with the corporation. This provision applies whether the director is a party to the contract or transaction personally or is a director or officer of, or has a material interest in, a party to the contract or transaction. As such, all conflicts or potential conflicts the director has, as a result of their relationship with the nominating party or other portfolio companies, must be disclosed. In situations of conflict, the statutes require the director to refrain from voting on any resolution to approve the contract or transaction except in narrow circumstances.

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 foreign private equity investment into Canada, an unlimited liability company (ULC) is often used as the ultimate Canadian company in the ownership chain. 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

Over the past few years, evergreen or ultra-long-term funds have become increasingly common, which has likely impacted the number of transactions. Other trends include the increased prevalence of co-investments by private equity funds, and direct investments by Canadian pension funds both locally and abroad.

While depressed oil prices have impacted both the volume of deals and the amount invested in the oil and gas industry, overall, the current conditions favour a robust private equity market in Canada’s Oil Patch. The decline in the Canadian dollar and the related reduced acquisition costs for foreign purchasers of Canadian companies, make inbound private equity investment particularly attractive at this time.

Notwithstanding a recent rebound in the Canadian IPO market, the IPO market is still very slow and M&A exits continue to be more prevalent (about 92 per cent of the overall value of the exits in 2016).

The challenges in Canada’s Oil Patch continue due to low global oil prices. Deal volume and deal size are both down during the first half of 2016. However, this is still an important sector that generates important private equity activity and that saw C$2.6 billion invested in oil and gas and power deals in the first half of 2016.

ii Financing

Traditional senior secured debt obtained from a domestic Canadian bank, often in the form of a revolving credit facility or term loan, remains the most common source of debt financing in Canadian private equity transactions.

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 last couple of years, the high yield bond market was not 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 range 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 5.0x EBITDA with a mix of senior debt of 3.0x to 4.0x and subordinated debt of 0.5x to 1.0x. We have seen transactions in which the debt leverage was pushed to 6.0x 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:

a. type of facility;
b. security interest (usually first lien over the assets in the case of a senior facility);
c. borrowing base and funds available under the facility;
d. repayment of capital;
e. interest rate and interest payment;
f. 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;
g. conditions precedent to disbursement; and
h. 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.

Foreign investors, largely US-based, account for a substantial portion of private equity investment in Canada. US investors may bring their American debt financing with them or obtain Canadian debt financing. Private equity investors utilising US debt sources for Canadian private equity transactions need to develop FX hedging strategies which are typically only provided by traditional banks and can be costly.

iii Key terms of recent control transactions

The increase in foreign investment, typically from the United States, has influenced transaction terms that have gradually shifted to become increasingly similar to those in the American market.

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 adjustment. Earn out provisions are also often contemplated by private equity buyers in order to link the seller’s ultimate consideration to the financial success of the target entity post-closing.

Private equity sellers and management teams will try to minimise the representations and warranties and insist on a short survival period for representations given. Private equity sellers will further try to limit their exposure by ensuring they do not include a full disclosure, 10b-5 type, representation, by liberally using materiality qualifiers and by including an anti-sandbagging provision.
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.

While still not common practice, 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.

It is advisable for private equity investors to build restrictions on the scope of representations and warranties that fund investors are required to give on a sale transaction. Representations and covenants as to the portfolio company’s operations are more properly given by management shareholders who will have in-depth knowledge in this regard. Private equity investors required to indemnify a purchaser in respect of breach should do so on a several basis and limitations should be placed on the dollar amount for which private equity investors are responsible. Typically, post-closing indemnification on the sale lasts 12–24 months (with fundamental representations and warranties lasting longer) and negotiated indemnity caps are often in a 10 to 50 per cent range of the sale price.

While representation and warranty insurance is becoming more popular, the traditional approach is a seller indemnity coupled with a purchase price holdback or escrow. Such measures are still very common in Canada for both private equity buyers and sellers. In the event of an earn-out provision, set-off rights against the earn-out payment are also typical.

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 the norm, reverse break fees are beginning to appear more often in private equity transactions. These fees are typically negotiated as a fixed dollar amount. Due 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 2016. However, the total dollar value of exits increased. Almost all exits were by negotiated sales with almost no IPOs.

Two notable exits from 2016 were:

a the C$1.6 billion sale of WIND Mobile by a consortium of Private Equity funds including Tennenbaum Capital Partners, Globealive Capital, LG Capital Investors LLC, Novus Entertainment Inc, Serruya Private Equity, Shaw Communications Inc and West Face Capital Inc to Shaw, one of the largest reported private equity transactions in the first half of 2016; and

b the C$1.6 billion sale of Trader Corporation by Apax Partners to Thomas Bravo, one of the largest reported private equity transactions in the second half of 2016.
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, many legislations of general application have an impact on the activities of private equity sponsors in Canada.

i Corporate statutes

Canadian corporations may be formed and governed under a federal or provincial corporate statute that regulates certain corporate transactions including statutory amalgamations and plans of arrangement and extraordinary transactions including the sale, lease, or exchange of all, or substantially all, of the property of a corporation.

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 (ICA)

The acquisition by a non-Canadian of ‘control’ of a Canadian business that exceeds certain prescribed monetary thresholds is reviewable under the 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. For purposes of the ICA, the acquisition of one-third or more of the voting shares of a Canadian corporation will be presumed to be 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

Certain other federal statutes limit foreign ownership in specified industries, such as financial services, broadcasting and telecommunications (e.g., non-Canadians are not permitted to own more than one-third of the voting shares of a holding company that has a subsidiary operating company licensed under the Broadcasting Act).

Competition Act (CA)

A private equity investment which constitutes a merger may also be subject to regulation under the CA. Under this legislation, the term ‘merger’ is broadly defined to include
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.

Over the past few years, evergreen or ultra-long term funds have become increasingly common, which has likely impacted the number of private-equity owned corporations put into play on the sell side. Other trends include the increased prevalence of co-investments by private equity funds, and direct investments by Canadian pension funds both locally and abroad.

i Other notable topics

Resident Canadian directors

Depending on the jurisdiction of incorporation, the board of directors of a Canadian corporation may be subject to certain minimum residency requirements. Notably, boards of directors for companies incorporated under either the federal or Ontario statute, must consist of at least 25 per cent resident Canadian directors. Certain jurisdictions like Quebec, British Columbia, New Brunswick and Nova Scotia have no such requirements.

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

Creditors can initiate a receivership either privately or by court appointment. A private receivership is initiated when a secured party exercises a contractual right to appoint a receiver pursuant to a security agreement. Private receivership is usually the quickest and least expensive alternative for secured creditors.

Bankruptcy and Insolvency Act (BIA)

Under the 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 a receiving order is made against it, the debtor’s assets will vest in the trustee in bankruptcy, subject to the rights of secured creditors. The BIA allows a debtor to make a proposal to all of its unsecured creditors, which may, at the debtor’s option, include secured creditors. To be accepted, each class of creditors must vote to accept the proposal by a majority in number and two-thirds in value. A proposal that is opposed by secured creditors will not be binding on the secured creditors.

**Companies’ Creditors Arrangement Act (CCAA)**

The CCAA allows an insolvent corporation with claims against it exceeding C$5 million to make a compromise or arrangement with some or all of its secured and unsecured creditors while continuing to operate its business. The plan of compromise or arrangement must be approved by a majority in number and two-thirds in value of each class of creditors voting. Once approved by the creditors, the court must sanction the plan. 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 United States 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 under the CCAA, which has very few procedural requirements.
I OVERVIEW

The private equity industry has continued to develop in Chile but at rates lower than in previous years. Growth rates of 2.1 per cent for the year ended 31 December 2015 and an expected rate of 1.6 per cent for the year ended 31 December 2016 have certainly affected the investment activity generally. Chile continues to offer, however, an attractive business environment and a stable legal framework. Notwithstanding the important legal reforms pursued by the current government in critical areas such as constitutional amendments, taxation, employment, education, Chile still holds the first position in the LAVCA Scorecard ranking, which reflects regulatory, policy and market conditions for the private equity industry.1 There are three areas where Chile obtains high scores compared to other Latin American economies: protection of intellectual property rights, perceived levels of public corruption and strength of the judiciary. Confirming this, the 2016–2017 Global Competitiveness Report prepared by the World Economic Forum awarded Chile the first place in the competitiveness ranking for Latin America, and improvement of two tiers in the global ranking.2

By the end of 2015 (most recent available data) there were 80 investment funds with estimated aggregate investments of US$2.797 billion, plus 24 management firms. Those funds were divided as follows: 35 venture capital funds with investments of US$415 million, eight private equity funds totalling investments of US$100 million (considering only local funds) and 37 feeder funds holding aggregate investments of US$2.282 billion. Feeder funds experienced the highest growth rate with 12 new funds with investments reaching US$990 million. The number of private equity and venture capital funds also increased during 2015, with three new PE funds and three new VC funds.3

i Deal activity

Chile's main appeal to the PE and VC industries is that, unlike other countries of the region (such as Brazil or Mexico) the number of sponsors in the market is still limited; new players

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are attracted by the opportunity for better value. Depreciation of the Chilean peso during 2016 has made the country especially interesting for foreign investors, although this effect has been offset by the uncertainty created by recent structural legal reforms.

The larger players in Chile from the fundraising perspective are international sponsors such as KKR, The Carlyle Group, Apollo, Blackstone, EQT (i.e., funds with assets over US$50 million, and with a regional and not purely national focus) that use local feeder funds to raise capital mainly from institutional investors. In terms of PE investments, main players are also regional and international sponsors doing deals in Chile, such as Advent, CVC, Linzor Capital Partners or Southern Cross Group. Finally, some of the most relevant local sponsors are Auras, EPG Partners, Sembrador Capital de Riesgo, Equitas Management Partners, BTG Pactual, Activa Private Equity, NXTP Partners Chile and Moneda Asset Management.

The average size for PE/VC funds (not including feeder funds) is US$12 million.\(^5\) This is consistent with the nature of the investors participating in the industry (i.e., low participation of institutional investors) and with the profile of the deals that are seen in the region, which are generally within the small and lower-middle market.

Typically, foreign sponsors enter the country associated with local firms that have a better understanding of the local market. Generally, that same local firm is the one that creates local feeder funds if the foreign sponsor is interested in raising funds from local institutional investors.

During 2015, while the aggregate amount of private equity investments in the Latin American region decreased by 18 per cent, the number of deals increased only by 1 per cent. The final figures for 2015 indicated 310 deals for US$6.47 billion within Latin America.\(^6\)

Chile, in line with the rest of the region (other than Mexico and Peru), experienced a slow year compared to the previous period in terms of deal activity. There were a total of 14 reported deals in Chile during 2015, compared to 27 deals reported in 2014, for an aggregate amount of US$178 million, a 79.5 per cent decrease compared with 2014 when the aggregate amount of investments reached US$867 million. As measured by deal count, the period showed a 48.1 per cent decrease according to publicly reported deals. No exits were reported during 2015. During the first half of 2016, six deals were reported amounting for US$64 million of investments and one exit for non-disclosed amount was also reported.

The table below shows reported deals in Chile during 2015 compared with deals in other countries in the region:

<table>
<thead>
<tr>
<th>Country breakowns</th>
<th>2015 investments</th>
<th>2015 v. 2014 growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>No. of deals</td>
<td>US$ (millions)</td>
</tr>
<tr>
<td>Argentina</td>
<td>17</td>
<td>41</td>
</tr>
<tr>
<td>Brazil</td>
<td>149</td>
<td>3,166</td>
</tr>
<tr>
<td>Chile</td>
<td>14</td>
<td>178</td>
</tr>
<tr>
<td>Colombia</td>
<td>18</td>
<td>415</td>
</tr>
<tr>
<td>Mexico</td>
<td>88</td>
<td>2,268</td>
</tr>
<tr>
<td>Peru</td>
<td>19</td>
<td>378</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1</td>
<td>3</td>
</tr>
</tbody>
</table>

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5. Ibid.
### Chile

#### Country breakdowns 2015 investments 2015 v. 2014 growth (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>No. of deals</th>
<th>US$ (millions)</th>
<th>No. of deals</th>
<th>US$ deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central America &amp; Caribbean</td>
<td>4</td>
<td>19</td>
<td>-20.0</td>
<td>-88.7</td>
</tr>
<tr>
<td>Total</td>
<td>310</td>
<td>6,469</td>
<td>1</td>
<td>-18</td>
</tr>
</tbody>
</table>

Source: LAVCA Industry Data & Analysis 2016

The table below shows exits in Chile during 2015 compared with those in the other countries of the region:

#### Country breakdowns 2015 exits 2015 v. 2014 growth (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>No. of exits</th>
<th>US$ (millions)</th>
<th>No. of exits</th>
<th>US$ exits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>3</td>
<td>164</td>
<td>-25.0</td>
<td>177.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>25</td>
<td>1,579</td>
<td>4.2</td>
<td>-1.3</td>
</tr>
<tr>
<td>Chile</td>
<td>-</td>
<td>-</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Colombia</td>
<td>5</td>
<td>300</td>
<td>-50.0</td>
<td>-80.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>7</td>
<td>409</td>
<td>-22.2</td>
<td>59.0</td>
</tr>
<tr>
<td>Peru</td>
<td>6</td>
<td>77</td>
<td>100.0</td>
<td>-75.2</td>
</tr>
<tr>
<td>Central America &amp; Caribbean</td>
<td>5</td>
<td>451</td>
<td>25.0</td>
<td>76.2</td>
</tr>
<tr>
<td>Total</td>
<td>52</td>
<td>2,980</td>
<td>-13</td>
<td>-36</td>
</tr>
</tbody>
</table>

Source: LAVCA Industry Data & Analysis 2016

### ii Operation of the market

The terms of private equity deals are fairly consistent with US industry standards. Frequently, transaction documents are based on US forms (including contracts drafted in English). Usual terms include representations and warranties, purchase price adjustments, anti-dilution provisions (including full ratchets), affirmative and negative covenants, events of default, indemnities and non-compete clauses. Shareholders’ agreements are generally used for the corporate governance of the target company and to restrict the transfer of shares for the benefit of the private equity sponsor.

In some cases, the private equity seller may agree to escrow arrangements to secure buyer claims until the lapse of the statute of limitations (generally five years) or the shorter period set forth in the purchase agreement. Representations and warranties insurance has not been used in a Chilean deal yet. Arbitration is the preferred dispute resolution mechanism for these transactions in almost all instances.

A typical sale process starts with the negotiation by the parties of the basic terms and conditions of the transaction, typically in the form of a term sheet. Term sheets may include indicative offers subject to due diligence conditionality. Often, the buyer will conduct the due diligence before the announcement of the transaction to the market, but a fair number of deals are announced without any due diligence having been carried out. Diligence ‘outs’ remain the norm, but it is standard practice for sellers to impose minimum thresholds and objective tests. Definitive purchase agreements will still be subject to conditionality, especially as they are relevant to governmental consents. For instance, in concentrated markets the approval of the antitrust authority will be a likely requirement, and transactions in the utilities sector will also require approval by the relevant authority (the sanitary authority in the water
industry, the energy authority in the electric industry, etc.). If the sale process involves an initial public offering (IPO), prior approval by the Securities and Insurance Commission (SVS) will be required.

Unless there is an IPO, a deal will typically take between three and six months to close (of course, depending on the negotiations of the parties and the complexities of the deal, a particular transaction may take longer or shorter to close).

The management of portfolio companies usually have a significant portion of their compensation tied to stock options and other rewards linked to the performance of the company. Alignment of incentives and favourable tax treatment make this type of compensation very desirable in Chile.

II LEGAL FRAMEWORK

Chile allows for a number of corporate entities with different results in terms of control.

A Chilean corporation is managed by a board of directors, with certain specified decisions reserved to the shareholders.

A corporation can be publicly traded, or ‘open’, private or ‘closed’. An open corporation is one that has issued equity shares registered with the SVS. Registration is voluntary, except where the corporation has 500 or more shareholders, or if at least 10 per cent of its capital stock is held by at least 100 shareholders. Open corporations are supervised by the SVS. All other corporations are closed. Closed corporations are not subject to the supervision of the SVS unless they are issuers of publicly traded securities (whether equity or debt) or if otherwise required by a special regulatory frame (e.g., insurance companies).

Corporations are managed and controlled by a board of directors appointed by the shareholders. The board has the broadest authority over the corporation and its affairs. Closed corporations must have at least three board members, open corporations at least five.7

There are statutory withdrawal rights for shareholders pursuant to which a shareholder can put its shares to the corporation upon certain actions being approved.8

Corporations in Chile require at least two shareholders.

Chilean law also provides for a corporate type similar to Delaware’s limited liability company, with two critical distinctions: Chilean limited liability companies (LLCs) require a minimum of two members, and Chilean LLCs require unanimous consent to amend their charter in any respect, to accept new members or to allow existing members to assign their interest.

Share companies (SpAs) combine the best attributes of a corporation (free assignability of the equity interests) with the contractual flexibility of an LLC (the SpA does not require unanimous consent for amendments of its charter). An SpA can be formed by one or more persons (individuals or legal entities), and allows for any type of corporate agreement save for a few mandatory rules.

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7 An open corporation with a market capitalisation over a certain threshold (currently about US$50 million) must have at least seven board members.

8 Actions such as, *inter alia*, the conversion of the corporation into a different corporate type (LLC, SpA, etc.), a division or a merger of the corporation, a sale of substantially all of the assets of the corporation or the granting of guarantees or liens with respect to third-party obligations result in statutory withdrawal rights. A corporation’s charter may provide for additional withdrawal rights.
SpAs allow for a single equity holder and can have as many equity holders as desired. If an SpA, however, reaches the number of equity holders that would render a corporation an open corporation, then it will automatically become an open corporation.

If provided for in their charter, SpAs are allowed to make capital calls and issue equity interests if resolved by management (i.e., without the consent of the equity holders). Unlike corporations, there are no statutory pre-emptive rights (again, except as contemplated by the organisational documents). The organisational documents may indicate minimum or maximum percentages or amounts of capital that are to be directly or indirectly controlled by one or more shareholders. The repurchase of their own equity interests is allowed for SpAs. Contrast this with corporations, which can make capital calls only if agreed by the shareholders. Statutory pre-emptive rights apply to equity issuances by a corporation. Corporations are also generally prohibited from acquiring their own shares and must distribute minimum statutory dividends (at an amount of 30 per cent of net earnings).

Most notably, however, an SpA may issue preferred shares accruing fixed or variable dividends. Features like preferred dividends accruing from specific businesses or assets are permitted (i.e., tracking stocks).

Chile also has investment funds. These can be structured as public funds (which are subject to substantive regulations by the SVS restricting the type and amount of assets in their portfolios, transactions with affiliates and periodic reporting to the market) or private funds (which are not subject to such regulations). Only public funds can publicly offer their securities.

**i Sponsors’ controlling investment of an entity**

A sponsor seeking control of an investment in Chile will have to consider the specific features of each type of corporation.

Where the sponsor wishes to acquire control of a corporation, it will require at least the control of the number of shares required to control the board of directors and corporate decisions in shareholders’ meetings – typically a majority of the outstanding shares. A number of material corporate actions require approval by at least two-thirds of the outstanding shares. Some of those actions (such as the sale of more than 50 per cent of the assets and the creation of preferred shares) are material to private equity or venture capital sponsors. No corporate actions require unanimous consent of the shareholders.

Chilean law explicitly recognises shareholders’ agreements and provides that they need to be ‘deposited’ with the corporation as a condition of the parties to it making claims against third parties based on such agreements. Chilean law, however, provides that shareholders’ agreements are not enforceable against open corporations insofar as they create restrictions on the transfer of shares. As a result, frequently liquidated damages clauses are agreed to by the parties in amounts large enough to create the appropriate incentives.

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9 Actions such as, *inter alia*, the conversion of the corporation into a different corporate type (LLC, SpA, etc.), a division or merger of the corporation, a sale of more than 50 per cent of its assets, a decrease in its equity capital, the valuation of equity contributions made in assets other than cash or a reduction in the number of members of the board of directors.

10 Section 14 of the Chilean Corporations Act.

11 In general, liquidated damages clauses are enforceable in Chile even if they are considered a ‘penalty’ or do not bear a direct relation to the expected damages caused by the breach of the relevant obligation.
SpAs provide the broadest flexibility in terms of contractual structuring provisions. The express recognition by the statute of contractual requirements in terms of maximum (or minimum) levels of equity interests held by its members, the fairly broad flexibility to trigger increases or reductions in equity capital and the ability to repurchase their shares, *inter alia*, make SpAs highly desirable vehicles for private equity investors.

Uniquely, SpAs’ charters can provide for ‘squeeze-outs’, whereby a minority holder can be forced to sell its interest upon another holder acquiring a certain threshold percentage. SpAs also allow for preferences consisting of multiple vote shares (and shares without voting rights).

In summary, a private equity sponsor will benefit significantly from the flexibility provided by an SpA when setting up a holding vehicle for its investment. By the same token, a sponsor investing in an existing SpA will need to conduct thorough due diligence and understand the implications of the SpA’s organisational documents.

**ii Structuring considerations for sponsors not domiciled in Chile**

The key structuring considerations will be driven by control issues (as previously discussed), tax issues and the regulatory framework relevant to the industry in which the investment is made. For example, a number of activities in Chile have to be – at least directly – performed by corporations (banking, insurance, retirement funds administrators, utilities, infrastructure concessionaires, etc.). In addition, corporations are the only corporate entity that allow for an IPO.

Similar to US tax law, Chilean law creates incentives for the use of leverage in a private equity transaction. Subject to certain conditions, Chilean tax law allows for tax deductions on account of interest payments. The same deduction does not exist for dividend payments.

Ordinarily, dividends remitted to non-Chilean sponsors are subject to a 35 per cent withholding tax rate. Interest payments are taxed at the same 35 per cent rate, but a 4 per cent reduced withholding rate applies, *inter alia*, to interest payments on loans made by foreign banks and financial institutions. In some cases, however, such as when the debt is guaranteed with cash or cash equivalents provided by third parties, or when the lender is an affiliate of the borrower, in order to qualify for the reduced 4 per cent rate a 3:1 debt-to-equity ratio will have to be satisfied every year when an interest payment is made.

When structuring a transaction as a leveraged buyout, sponsors will have to ensure that the *pro forma* amount of debt of the target company (including the debt raised to finance the LBO) allows the surviving company to remain solvent. Chilean bankruptcy courts have jurisdiction to void transactions resulting in insolvent entities.

It is common to bridge a leveraged deal using short-term debt and then to refinance with long-term securities in the bond market or with a long-term secured loan.

Another reason for leveraging up a deal is that remittances of equity contributions to a foreign sponsor are first allocated to taxable retained earnings and profits (assuming the Chilean company is taxed under the ‘partially integrated system’). Accordingly, outflows of capital contributions can only be tax free if the Chilean business does not have accumulated earnings and profits that are taxable (starting on 1 January 2017, if the Chilean company is taxed under the ‘attributed income system’, the investor will pay taxes for 100 per cent of the taxable income every year, regardless of its distribution, and therefore repatriation of capital contributions will always be tax free under this regime). There is no such requirement affecting principal payments on debt transactions.
iii Fiduciary duties and liabilities

The main source of fiduciary duties in the Chilean corporate context is the Corporations Act and its regulations. Directors of a corporation have an obligation to act with the degree of care and diligence that they would apply in their own affairs. They are jointly and severally liable for damages caused to the corporation or its shareholders for their fraudulent or negligent actions. The same principles apply to an SpA, unless it is not managed by a board of directors or unless provided otherwise in the SpA by-laws. As a result, a private equity sponsor will not be directly exposed to liability with regard to other shareholders. The shareholders of a corporation (or an SpA) do not generally owe fiduciary duties to each other, and are permitted to act in their own self-interest. They might be liable to the corporation (or SpA) for losses arising from breaches to the Corporations Act, the company’s by-laws or the rules issued by the SVS.

Areas of concern for a sponsor arise in the insolvency context. While the Chilean courts do not apply the ‘zone of insolvency’ test to the same extent that a court in the United States might, the Chilean Bankruptcy Act does provide for liability on account of actions that are fraudulent to creditors. For example, Chilean courts may void a sale of assets consummated within two years of the insolvency of a company. They are, however, very unlikely to find liability for a sponsor other than in the very narrow circumstances of a fraudulent voidable transaction expressly provided for in the Bankruptcy Act or under criminal fraud statutes.

During the last four years the SVS has focused on compliance with the legal and regulatory requirements in connection with related party transactions (OPRs). The criterion applied by the SVS to qualify a transaction as an OPR has been determined largely by specific facts and circumstances. For instance, in 2012, a capital increase in the energy company Enersis, was qualified as an OPR because the controller was paying for the equity shares issued to it, pursuant to the capital increase, in kind, while the minority shareholders had to pay for their shares in cash. On the other hand, a broad reorganisation of that same company in 2015, including several mergers and splits among Enersis and its subsidiaries, was not deemed an OPR by the SVS, even though the latter required to satisfy procedures and formalities applicable to an OPR. In the first case, assessing the fair market value of the assets that are being contributed by the controller as payment of the purchase price for its equity shares, and in the second case, assessing the fair market value of the company that is being merged into another company, were one of the main concerns for the minority shareholders, and characterising the transactions as an OPR could make a big difference in connection with that valuation process. In a private equity context, special attention should be paid to agreements between the holding company, the sponsor and the managers, on the one side, and the target or operating company on the other side, when the latter is a public

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12 Section 41 of the Corporations Act and Section 78 of the Corporations Act regulations.
13 Section 424 of the Chilean Commercial Code.
14 Delaware courts have created the ‘zone of insolvency’ concept, effectively extending fiduciary duties of a board of directors to creditors when a corporation is close to insolvency. See Credit Lyonnais Bank Nederland, NV v. Pathé Communications Corp, 1991 WL 277613 (Del Ch 30 December 1991); Weaver v. Kellogg, 216 BR 563, 582-84 (SD Tex 1997); Official Comm of Unsecured Creditors of Buckhead America Corp v. Reliance Capital Group, Inc (In re Buckhead Am Corp), 178 BR 956, 968 (D Del 1994).
15 Sections 287 to 293.
corporation subject to the supervision of the SVS. This discussion might also be relevant in an acquisition involving a public company, were part of the purchase price is paid with shares of the purchaser or of another company, or in general, with any assets different from cash.

III YEAR IN REVIEW

i Recent deal activity

An interesting deal from a fundraising standpoint was the recent closing by Greystar Real Estate Partners, LLC and Credicorp Capital of their multifamily development fund, which will focus on residential real estate development in Santiago. This deal continues with the trend across the region of international sponsors partnering with local players to leverage their experience and knowledge of the local housing market. Until this point no major corporate players had entered the rental housing business in Chile.

One of the largest investments of the year was the acquisition by Southern Cross of 100 per cent of Petrobras’ distribution assets in Chile for US$464 million. The sale is part of a wider divestment plan of the Brazilian state-owned company. Another important investment was in the banking and finance sector, where IFC made a US$140 million equity investment in Consorcio Financiero. The investment gives the IFC an 8.3 per cent stake in the Chilean company. The lack of liquidity of Chilean capital markets and the property structure of most of Chilean companies (i.e., property concentrated in a few owners generally part of the same family or economic group) makes this kind of minority deals common in Chile.

The energy industry, which was very active during 2014–2015, also experienced certain movement during 2015–2016. An interesting deal in this space was the acquisition by a consortium comprised of the Chilean generation company Colbún, the Abu Dhabi Investment Authority and Sigma SAFI’s Infrastructure Fund of 100 per cent of the thermoelectric generation company Fenix Power Perú. Another relevant deal was the sale of Duke Energy’s assets in Peru, Chile, Argentina, Guatemala, El Salvador and Ecuador.

Finally, in the telecom space the main deal of the year was the acquisition by UK private equity fund Novator Partners of 92 per cent of Chilean telecom company Nextel Chile.

ii Financing

From a regulatory standpoint, it is worth noting that Chilean institutional investors, especially pension funds, are a key source of liquidity for private equity in Chile. Banks are also authorised to participate in private equity deals through their affiliates. Restrictions on the amounts invested (determined as a percentage of their assets) apply. International private equity firms generally use local feeder funds to raise capital from institutional investors.

The recently enacted Law 20,956 allows pension funds to invest in securities, operations and contracts representing real estate assets, private equity investments, private debt, infrastructure and other types of assets (alternative assets) to be determined in related regulations called the Investment Regime for Pension Funds. This Investment Regime must specify the securities, operations and contracts authorised for pension funds’ investments and the conditions that such investments must meet. The law also allows for investments in bonds issued by investment funds regulated by Law No. 20,712 (the Unified Funds Law). The investment regime shall also forth the conditions that these instruments must meet and a maximum limit for investments in alternative assets that shall range between 5 per cent and 15 per cent of the value of the pension fund, and may be different for each type of pension fund (currently pension funds may invest up to 2 per cent of their assets in quotas of
investment funds). Finally, the new law also increases the maximum participation threshold applicable for investments in a single investment fund by pension funds managed by a single pension fund manager (AFP) from 35 to 49 per cent. All these amendments will be effective from 1 November 2017.

The Chilean Economic Development Agency (CORFO), the state development agency, is a significant source of financing for private equity and venture capital. CORFO encourages entrepreneurship and innovation by providing resources to start-ups or in key sectors of the economy. CORFO can provide direct financing (up to 40 per cent of the equity of a company) or financing through lines of credit available to private equity or venture capital investors. CORFO’s financing can be unsecured, thereby allowing for additional third-party leverage on a secured basis. By the end of 2015, CORFO had committed equity contributions to 39 out of the existing 43 private equity or venture capital funds (excluding feeder funds), for a total amount of US$560.33 million committed funds, of which US$355.92 millions were effectively disbursed. Those investments were made primarily in venture capital funds (85 per cent) and only five private equity funds received financing from CORFO.16

IV REGULATORY DEVELOPMENTS

i Regulatory bodies of the industry

Except for specific instances in the context of regulated industries, private equity transactions are generally not subject to special regulations restricting them. If a transaction involves public investment funds or public companies, a private equity sponsor is likely to have to deal with the SVS, which may exercise its overseeing powers. Private investment funds and private companies (including SpAs), on the other hand, are not supervised by the SVS.

For an IPO, both the issuer and its securities to be offered to the public need to be registered with the SVS. An application describing in detail the terms and conditions of the offer is required, and must include extensive information regarding the company (ownership structure, legal information, accounting, business and activities, risk factors, etc.) and its securities. The SVS has ample discretion to approve an application, and usually it will exercise it by asking for further information and for changes to the way information is presented. Once the observations are resolved, the issuer and the shares will be registered in the Securities Registry of the SVS. The SVS making observations is very common; however, an application not ending in an approved registration is extremely unusual.

ii Regulatory developments

One of the main regulatory developments was the enactment of Law 20,956 (explained in more detail in Section III.ii, supra).

Another relevant development was the issuance by the SVS of general rule No. 410, which supplements the list of entities that qualify as ‘institutional investors’ pursuant to the Securities Market Act (Law No. 18,045). The importance of who qualifies as an ‘institutional investor’ pertains, among others, to the rules applicable to funds and portfolio management. The Unified Law on Funds (Law No. 20,712) grants certain flexibility to those funds that have an institutional investor as a shareholder. For example, a publicly traded fund may

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have fewer than 50 shareholders if at least one of them is an institutional investor. Likewise, private investment funds may have fewer than four non-related shareholders (each of them holding at least 10 per cent of the shares) if they have one shareholder that is an institutional investor and that holds at least 50 per cent of the shares of the fund. This is very relevant to private investment funds, because if they don’t comply with these structural restrictions they would be treated for tax purposes as closed corporations, losing all the tax benefits of a private investment fund.

Starting on 1 January 2017, the new tax regime enacted during 2015 will be fully effective. A key aspect of the new tax law is the increase on the corporate tax burden for Chilean companies from the current 24 per cent rate to 25 or 27 per cent, depending on the regime companies adopt. For this purpose, the amended income tax law provides for two new tax regimes: (1) an attribution regime that levies a 25 per cent tax rate on incomes obtained by companies in each tax year, which will be immediately allocated to their shareholders; and (2) a partially integrated regime that levies with 27 per cent tax rate incomes obtained by companies. Under the second regime, shareholders are allowed to defer personal and withholding taxes until such profits are effectively distributed, but it only allows the use of a 65 per cent credit of the taxes paid by the company, unless the shareholder is resident in a tax-treaty country. The taxable basis of the corporate tax is broadened by way of new controlled foreign entities (CFC) rules; modified thin capitalisation rules; disallowance and limitation of deductions; limitation on the use of tax losses, and limitation of preferential capital gains regimes and tax-free investment fund vehicles, among others. Goodwill in excess of the market value of assets ceases to be subject to amortisation for tax purposes.

Finally, new merger control and antitrust regulations have also been enacted. A mandatory merger control regime will become effective in June 2017. As a result, deals closed after 1 June 2017 will be subject to the new clearance regime. The new merger control regime requires ‘concentration transactions’ exceeding certain thresholds to be filed with the Antitrust Agency (FNE) prior to their consummation. The FNE shall have 30 days to approve the operation (unconditionally or subject to conditions). The 30-day term may be extended up to 90 days. A concentration transaction is subject to filing only if: the aggregate sales in Chile, during the immediately preceding year, by all the parties intending to merge or consolidate are equal to or higher than, approximately US$70 million; or the sales in Chile during the immediately preceding year by at least two of the parties intending to merge or consolidate, are equal to or higher than approximately US$11.3 million.

V OUTLOOK

The Chilean PE market has grown significantly during the last years but compared to other economies in the region (such as Brazil and Mexico), and other emerging markets in the world (such as Ireland), the PE activity in Chile remains relatively underdeveloped and represents a small percentage of the country’s GDP (0.35 per cent by the end of 2014). Even though Chile has a competitive economy and a stable business environment, it still presents issues that impact its attractiveness for the PE industry. Relative lack of liquidity of its capital markets, including a limited banking market for raising local debt for leveraged buyouts. Nevertheless, Chile has a strong entrepreneurship environment and there is a long-standing commitment from the Chilean government to support and finance new businesses, as it is shown by the significant role that CORFO has in the financing of new business ventures.
Some of the new policies being implemented to improve the regulatory framework for investors in Chile and for Chilean pension funds, the continued growth of Chile’s economy, the current deficit of infrastructure together with lower interest rates and the relatively early stage of the private equity industry in Chile suggest the private equity activity in the country will continue to grow within the next few years.17

17 The Investment Regime for Pension Funds regulates specific matters of the investments of pension funds that, by their nature, require greater flexibility and detail. It also defines the limits of investment in order to promote a suitable diversification of funds.
Chapter 6

CHINA

Huin (Amie) Tang and Xiaoxi Lin

I OVERVIEW

Private equity activity in China in 2016 moderately cooled down from the all-time peak level in 2015, with a year-on-year decline in terms of both volume and value of investments. According to AVCJ Research, the market research division of the Asian Venture Capital Journal, based on its data as of 19 January 2017, there were 1,068 private equity investments (of which 823 were publicly disclosed) with an aggregate amount invested of US$49.3 billion in China in 2016. Compared with 1,338 investments with an aggregate amount invested of US$70.5 billion in 2015, the total volume of investments decreased by 20.2 per cent and the total value of investments decreased by 30.0 per cent in 2016.

The distribution among different investment types in 2016 exhibited a further uptick of start-up and early stage investments, and a slump in buyouts and private investments in public enterprises (PIPE) financing compared with that of 2015. According to AVCJ Research:

a investments at expansion and growth stages stayed ahead of other investment stages at US$19.07 billion or 38.7 per cent of total investment value in 2016, down from US$28.85 billion or 40.9 per cent in 2015;

b venture capital deals in the start-up and early stages rose from US$12.99 billion or 18.4 per cent of total investment value in 2015 to US$15.88 billion or 22.5 per cent of total investment value in 2016;

c PIPE trimmed down to US$5.79 billion or 11.7 per cent of total investment value in 2016 from US$9.39 billion or 13.3 per cent of value in 2015; and

d buyouts declined sharply from US$15.50 billion or 22.0 per cent of total investment value in 2015 to US$7.76 billion or 15.7 per cent of total investment value in 2016.

Although buyouts remained relatively less frequent in comparison with deal activity in many other jurisdictions, and its share declined in 2016 compared with 2015, it remains an important type of private equity investment in the Chinese market. The buyouts trend that began in 2010 further emerged in 2011, grew in 2012 to 2014 amid 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

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received going-private proposals in prospect of seeking future listing on China’s A-share market or Hong Kong stock exchange, followed by a decline in 2016. Despite the overall decline in 2016, the going-private space remained relatively active in 2016. Based on statistics obtained through searches on Thomson ONE, the Thomson Reuters database, of the 184 going-private transactions that have been announced since 2010, 39 did not proceed (14 of which involved private equity sponsors) and 124 have closed (five in 2010, 13 in 2011, 19 in 2012, 18 in 2013, 25 in 2014, 14 in 2015, 29 in 2016 and one in 2017). As of 31 December 2016, 21 going-private transactions were pending, including three announced in 2012, one announced in 2013, two announced in 2014, seven announced in 2015 and eight announced in 2016. Of the 124 completed going-private transactions, 31 involved private equity sponsors, and of the 21 pending going-private transactions, six involved private equity sponsors.

In respect of exits via IPO, China experienced the longest moratorium of A-share IPOs in history from November 2012 through December 2013, and another four-month moratorium of A-Share IPOs in 2015. Private equity-backed IPOs in 2016, an exit route China-focused private equity funds used to heavily depend on, continued to retreat from 2015 with a 31.9 per cent decrease in terms of value realised in listing, despite the slight 8.9 per cent increase from 2015 in terms of deal count, according to AVCJ Research. Exits via trade sales and secondary sales, accounting for 55.2 and 12.1 per cent respectively of private equity-backed exits in 2015, and 80.8 and 5.9 per cent respectively in 2016, according to AVCJ Research, remained the dominant exit options for private equity funds in 2016, and likely will continue to maintain this position for the foreseeable future.

2016 has also witnessed record-hitting levels of activity in Chinese outbound M&A. Chinese investors are more and more active and discerning in acquiring mature assets in advanced economies, and notching up a series of high-value cross-border M&A deals. According to PwC M&A 2016 Review and 2017 Outlook, based on data from Thomson Reuters, China Ventures and PwC’s analysis, compared with 2015, Chinese outbound M&A in 2016 surged 142 per cent in terms of the number of announced deals to 923 and 246 per cent by announced deal value to a record high of US$220.9 billion, which exceeded the combined deal value in the previous four years. The proposed US$43 billion acquisition of Syngenta AG, a Swiss agrochemical and seeds company, by China National Chemical Corporation, a Chinese state-owned chemical company and Fortune Global 500 company, if completed, will overtake CNOOC’s 2012 purchase of Canadian energy company Nexen to become the biggest outbound investment ever made by a Chinese buyer. Announced in February 2016, the transaction is currently under merger review at the European Commission and other regulatory review. Outbound M&A backed by Chinese financial investors also heated up in 2016, more than doubling in terms of announced deal volume and rising 149 per cent in terms of announced deal value to US$38.1 billion compared with 2015.

II REGULATORY FRAMEWORK

i Acquisition of control and minority interests

China’s Companies Law, which became effective on 1 January 2006 and was amended in 2013 with effect from 1 March 2014, sets out the governance framework for the two types of Chinese companies: company limited by shares and limited liability company. 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.
China

(WFOE), an equity or cooperative joint venture (CJV), 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 a FICLS), including their respective implementation rules. The Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (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. There are also other statutes and rules governing transfers of equity, mergers and other transactions involving FIEs.²

On 19 January 2015, the central Ministry of Commerce (MOFCOM) released a draft of the proposed new Foreign Investment Law (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, 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 likely be repealed, while other statutes and rules on foreign investments would require amendments to adapt to the new regime.

Government approval regime

An acquisition of or investment in a Chinese company by a non-Chinese investor is subject to a multi-layered government approval and registration process. Subject to the recent developments described in Section IV.i, infra, in respect of the record-filing regime applicable to FIEs, the highest-level of scrutiny is applicable to onshore investments (that is, direct acquisitions of equity in Chinese companies), which require the approval of the National Development and Reform Commission (NDRC) or its local counterpart and central MOFCOM or, if the size of a greenfield investment falls below US$300 million, or the size of an acquisition falls below US$100 million or the size of either an acquisition or other investment in ‘restricted’ sectors specified in the Foreign Investment Catalogue (as discussed below) falls below US$50 million, MOFCOM’s local counterpart. Approval at the local level typically can 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 antitrust or national security review as discussed below, MOFCOM or its local counterpart would typically defer review until such antitrust or national security reviews are completed.

Whether MOFCOM and NDRC will grant approval for a transaction depends in part on the Catalogue for the Guidance of Foreign Investment Industries (Foreign Investment Catalogue), jointly published by MOFCOM and the NDRC, which classifies sectors of the Chinese economy as ‘prohibited’, ‘restricted’ or ‘encouraged’ (with unclassified sectors deemed as ‘permitted’). Whereas a non-Chinese investor can acquire full ownership of a company

in most ‘encouraged’ and ‘permitted’ sectors (and often benefits from special advantages when acquiring a company in an ‘encouraged’ sector), to invest in most ‘restricted’ sectors, a non-Chinese party 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 investment in several industries, such as construction or telecommunications, is subject to approval from the regulatory authorities governing the applicable industry.

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 or 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.

Under the Anti-Monopoly Law (AML), which became effective on 1 August 2008, an antitrust filing with MOFCOM 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 the parties’ aggregate worldwide sales in the prior accounting year exceeded 10 billion or the parties’ aggregate sales in China in the prior accounting year exceeded 2 billion. According to MOFCOM’s 2016 annual review relating to AML, throughout 2016, MOFCOM received 378 merger notifications (7.4 per cent more than in 2015) and closed 395 cases (19 per cent more than in 2015), among which MOFCOM imposed conditions on two transactions (the same number as in 2015). On 30 May 2016, MOFCOM announced its approval of Walmart’s petition for removing the restrictive conditions imposed by MOFCOM in the prior conditional antitrust clearance decision made in 2012 with respect to Walmart’s purchase of 33.6 per cent shares in Niuhai Holdings Limited, which is the offshore financing vehicle of Yihaodian, a leading online supermarket and e-commerce platform in China. This was the second decision made by MOFCOM to remove restrictive conditions, which followed MOFCOM’s decision announced in January 2015 to remove a restrictive condition imposed on Google’s acquisition of Motorola Mobility. In May 2016, MOFCOM published three administrative decisions to impose fines on three transactions for failure to comply with the merger notification requirements. These three decisions were new instances of penalties imposed by MOFCOM for violation of the merger notification requirement following the first such type of decision published in 2014 imposing fines on a merger transaction for non-compliance with the merger notification requirement (while there were two other MOFCOM decisions published in 2014 imposing fines on Western Digital for its non-compliance with the restrictive conditions imposed by MOFCOM in its merger control clearance decision relating to its acquisition of Hitachi Storage), and four MOFCOM decisions published in 2015 imposing fines on four merger transactions for non-compliance with the merger notification requirement.

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: 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 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 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. Under these Tentative Measures, the national security review extends to foreign investment in important cultural and IT products sections 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 proprietorships, joint ventures, equity or asset acquisitions, control by contractual arrangements, nominal holdings of interests, trusts, reinvestments, offshore transactions, leaseholdings and subscriptions 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 investment (not limited to ‘acquisition’) 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 reinvestment, lease, loan, contractual control, offshore transaction or other such structures. 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. In June 2014, MOFCOM issued the revised guidelines on antitrust filings, with attempts to clarify the moderately controversial concept of ‘control’ in the context of antitrust filing, and to provide for a formal pre-filing consultation with the Anti-Monopoly Bureau of MOFCOM available to investors to assist them in determining whether a filing would be triggered. If a transaction is subject to national security or antitrust review, MOFCOM conducts 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 the 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 is still permitted.

In contrast, the Draft FIL is proposing a shift from current case-by-case approval for all foreign direct investments to a refined regime, namely an ‘entry clearance review’, applicable only to foreign investments in ‘restricted’ sectors on a Negative List that is to be promulgated (which, it is expected, will supersede the Foreign Investment Catalogue). 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 Negative List, certain types of indirect investments may unprecedentedly come within the purview of Chinese regulators.

**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 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 (EJV) 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, including:

- any amendment to the articles of association (which is required in connection with any equity transfer);
- any liquidation or dissolution;
- any increase or decrease in registered capital; and
- any merger or division.

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, such 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 approval of MOFCOM 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 bid 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 regulatory framework on 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 or British Virgin Islands company, with such 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. Under a VIE structure, Chinese individuals, often the founders, 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 such operating company. These contractual arrangements can take many forms, but often include an exclusive service or licence agreement, a voting proxy agreement, share pledge agreement and 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 affiliate (or affiliates) or designee (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 continue to use this structure.

However, the Draft FIL is a strong signal from the government of its long speculated-upon attempts to address VIE structures, primarily by formalising the regulation of a VIE structure via the concept of ‘de facto control’, as previously mentioned. This warrants the vigilance of current and future investors, and would have a profound impact on prospects of investment in certain Chinese businesses. The Draft FIL has clarified that future investments via VIE structures controlled by foreign investors will be treated as foreign investment, which may trigger entry clearance and other reviews. Further, instead of godfathering the pre-existing VIE structures, the Draft FIL leaves a placeholder for how pre-existing VIE structures would be handled under the new regime, while an explanatory note from MOFCOM accompanying the Draft FIL puts forth suggested approaches in dealing with businesses with VIE structures. In this note, MOFCOM has left room for public comments and undertakes to propose solutions upon further study.

ii Fiduciary duties and liability

Fiduciary duties of directors, officers and supervisors

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 a duty of loyalty and a duty of 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 general manager or chief financial officer. Most non-Chinese private equity funds are comfortable appointing their representatives to the boards of Chinese companies notwithstanding the risk of liability, often while seeking to ensure that their representatives are not assigned responsibility for any specific matters. 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 PRC issued Circular (2015) No. 7 (Circular 7) on Chinese corporate income tax treatments of indirect transfers of PRC 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 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 the parties to such offshore transaction have the discretion to determine whether to make a Circular 7 filing to report such offshore transaction for Chinese tax authorities’ assessment for Chinese tax purposes, Circular 7 employs a penalty structure designed to motivate the parties to offshore transactions involving indirect sales of Chinese companies to report potentially taxable transactions to the tax authorities. Because of the uncertainty and evolving practice of the Circular 7 regime regarding what will satisfy the tax authorities as a non-tax-avoidance justification and having reasonable commercial purpose for the offshore sale of Chinese entities, 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 such 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:

- the offshore vehicle locates its senior management and core management departments in charge of daily operations in China;
- financial and human resources decisions of the offshore vehicle are subject to determination or approval by individuals or bodies in China;
- 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
- 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 are subject to such tax, an offshore vehicle should take steps to establish that it is not effectively managed and controlled in China.

**Securities Exchange Commission (SEC) enforcement actions**

The SEC Enforcement Division has continued to focus on companies with operations or activities, or both, in China, but that are trading on US exchanges. While the SEC enforcers have always been interested in investigating allegations of accounting fraud, they have expanded their focus to books and records and internal controls issues even in the absence of accounting fraud. The SEC’s expanded enforcement focus is not surprising given there have been fewer instances of pervasive accounting abuse in 2016, such as Chinese reverse-merger fraud or stock-option backdating.

For companies with operations in China, the SEC has utilised the accounting provisions of the Foreign Corrupt Practices Act (FCPA), which requires all issuers\(^3\) to have a system of internal accounting controls that provides reasonable assurance that transactions are according to management directives and are properly recorded; and make and keep accurate books, records and accounts that accurately and fairly reflect transactions and the distribution of the company’s assets.\(^4\) Unlike the anti-bribery provisions of the FCPA,\(^5\) the accounting provisions do not require the underlying conduct to have jurisdictional nexus with the US or any evidence showing corrupt payments. Therefore, the SEC enforcers frequently invoke the accounting provisions on grounds of deficient or false records, or inadequate internal controls, or both.

Among the 25 corporate FCPA cases brought by the SEC in 2016, over 50 per cent involved a multinational’s Chinese subsidiaries or their activities in China, or both. Among others, one of the world’s premier investment banks, JP Morgan Chase & Co, agreed to pay more than US$130 million to settle SEC charges that the bank provided valuable job and internship opportunities to relatives and friends of senior government officials in Asia (in particular, almost 100 hires after alleged requests from more than 20 Chinese state-owned entities’ officials) in exchange for lucrative investment banking businesses.\(^6\) Additionally, JP Morgan was expected to pay US$72 million to the US Department of Justice (DOJ) and US$61.9 million to the Federal Reserve Board of Governors for the alleged conduct, bringing the total financial penalty to more than US$264 million.\(^7\) Similarly, on 1 March 2016, Qualcomm agreed to pay US$7.5 million to the SEC to settle charges that the company

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3 The term ‘issuer’ refers to any entities required to register under 15 USC 78 or file reports under 15 USC 78o(d). Therefore, foreign entities with American Depository Receipts are considered ‘issuers’ for the purpose of the FCPA.

4 15 USC 78m(b)(2)(A)-(B).

5 The FCPA’s anti-bribery provision prohibits making or offering any corrupt payment to any foreign government officials. The anti-bribery provisions apply to US ‘domestic concerns’ and any person in the territory of the US as well as the issuers. 15 USC 78dd-1-3.


7 Id.
provided full-time employment and paid internship opportunities, as well as lavish gifts and entertainment, to relatives and friends of Chinese government officials to influence these officials’ decisions on adopting Qualcomm’s mobile network technologies.8

Other significant FCPA enforcement cases brought by the SEC in 2016 include:

a) On 23 March 2016, the Swiss-based pharmaceutical company Novartis AG agreed to pay US$25 million to settle SEC charges that employees of the company’s Chinese subsidiaries used a ‘pay-to-prescribe’ scheme to provide gifts, recreational travel and fake studies to reward Chinese public hospitals’ health service providers who prescribed Novartis medications.9

b) On 30 September 2016, the UK-based pharmaceutical company GlaxoSmithKline agreed to pay US$20 million to settle SEC charges that employees and agents of the company’s Chinese subsidiary and joint venture partner provided cash, entertainment, gifts, travel and other items of value to influence the prescription decisions of Chinese public hospitals’ health service providers.10

c) On 4 February 2016, SciClone Pharmaceuticals agreed to pay US$12 million to settle SEC charges that the company provided improper payments to Chinese public hospitals’ health service providers to increase sales.11

d) On 29 December 2016, wire and cable manufacturer General Cable agreed to pay more than US$55 million to the SEC and nearly US$20.5 million to the DOJ to settle FCPA violations where its overseas subsidiaries made improper payments to foreign government officials to win business in Angola, Bangladesh, China, Egypt, Indonesia and Thailand. The company agreed to pay an additional US$6.5 million penalty to the SEC to settle separate accounting-related violations.12

e) On 30 August 2016, the SEC announced that UK-based biopharmaceutical company AstraZeneca has agreed to pay more than US$5 million to settle charges that it violated the books and records and internal controls provisions of the FCPA as a result of its wholly owned subsidiaries in China and Russia making improper payments to foreign officials.13

SEC enforcers not only brought FCPA actions against companies with Chinese operations in 2016; they have also imposed sanctions against China-based individuals on multiple occasions. On 13 September 2016, the former chair and CEO of a Florida-based technology company, Harris Corp, Jun Ping Zhang (Ping) agreed to pay US$46,000 in civil penalties and enter an SEC cease and desist order from future FCPA violations. The SEC alleged that Ping facilitated and directed his sales staff to use fabricated expense receipts to pay for gifts


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to officials at China’s state-owned hospitals to influence the officials’ decisions to purchase the company’s products and services. Notably, the SEC declined to take any action against Ping’s employer, Harris Corp, because Harris Corp discovered the conduct five months after acquiring the Chinese business that was led by Ping and then self-reported the conduct to the SEC and DOJ. Harris Corp had further terminated all of the implicated employees and shut down its China operations. Harris Corp reported that the DOJ had closed its investigation without bringing any charges against the company.

In 2016, the SEC also continued to focus on two other areas of enforcement involving Chinese traders: cybersecurity and insider trading. On 27 December 2016, the SEC announced charges against three Chinese hackers for allegedly stealing and trading confidential and material M&A information from two prominent New York law firms concerning their clients listed on US exchanges. This enforcement action marked the first time that the SEC has charged individuals for hacking into a law firm’s computer system. In a parallel action, the US Attorney’s Office for the Southern District of New York announced related criminal charges. At the time of writing, one of the hackers has been arrested in Hong Kong and is waiting for extradition to the US, while the other two remain at large. Furthermore, on 9 June 2016, a Chinese trader agreed to pay more than US$756,000 to the SEC to settle insider trading charges. It was alleged that the trader obtained material, non-public information when he served as a consultant to two Chinese private equity funds for a buyout deal and then generated illegal profits from the information.

**Chinese authorities’ enforcement actions**

In addition to heightened scrutiny from US regulators, foreign private equity investors also face risks posed by Chinese authorities’ anticorruption and antitrust enforcement actions. Such risks were showcased in continued enforcement actions against multinational companies.

**Chinese anticorruption enforcement update**

In 2016, Chinese regulators continued to focus on anticorruption enforcement against multinational companies that started with the highly publicised investigation of GlaxoSmithKline in 2014. Chinese regulators focused anticorruption enforcement on the pharmaceutical, medical device, automotive and construction industries, as well as new areas such as the internet. In October 2016, the Administration for Industry and Commerce (AIC) imposed a fine against tyre giant Bridgestone for commercial bribery. The fine amounted to 150,000 yuan, and included disgorgement of approximately 17.4 million yuan in illegal gains. Bridgestone was found to have offered shopping cards to retailers in exchange for product sales. Hewlett-Packard was also investigated for its connections to the son of a high-ranking government official. The criminal judgment, released on 14 July 2016, disclosed that a Hewlett-Packard employee bribed the son of the official and his close associate in an amount of over 1 million yuan to win bids for two projects.

In addition to targeting multinational companies, the Central Commission for Discipline Inspection (CCDI) commenced an inspection of the major SOEs in the financial services sector in late 2015, including the People’s Bank of China, the central bank, China’s

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stock exchanges, China's banking, security and insurance regulatory commissions, and other state-owned banks and insurers. CCDI continued its sweep in the financial services sector in 2016. In 2016, employees of several securities companies were reported to have been arrested in connection with alleged bribery of government officials in order to win projects.

The continuing anticorruption campaign was also bolstered by additional regulation in 2016. On 25 February 2016, the Legislative Affairs Office of the State Council released the draft amendment to the Anti-Unfair Competition Law (AUCL), the primary legal authority in China on commercial bribery. The draft amendment introduces a number of significant changes to the AUCL, including a broader definition of commercial bribery, increased penalties for commercial bribery by companies, vicarious liability for acts of employees, and tightened record and bookkeeping requirements. The AUCL currently provides for an administrative fine of 10,000 yuan to 200,000 yuan, plus the confiscation of illegal gains. The draft amendment increases the fine to 10 to 30 per cent of the revenue generated from the business involving commercial bribery. How these changes will impact enforcement and penalties is yet to be seen.

Chinese antitrust enforcement update

In 2016, China continued its aggressive antitrust enforcement actions. China's enforcement authorities issued the most penalty decisions (27) in one year, including a number of high-profile enforcement actions against multinational corporations that resulted in significant penalties totalling hundreds of millions of US dollars. Three of the largest fines included Tetra Pak, Medtronic and General Motors. On 9 November 2016, the AIC fined Tetra Pak, a multinational food packaging company, for abusing its dominant position in China's aseptic packaging machine, technology service and materials markets. The AIC imposed fines totalling 668 million yuan, which amounted to 7 per cent of Tetra Pak's 2011 sales revenue from the relevant products. On 5 December 2016, NDRC fined Medtronic 118.5 million yuan, or 4 per cent of its 2015 sales revenue from relevant products, for price fixing and setting limits on resale prices in the markets of cardiovascular, rehabilitation therapy and diabetes devices. Likewise, on 23 December 2016, the NDRC's Shanghai branch fined SAIC-GM for manipulating resale prices through agreements with distributors, imposing a penalty of 201 million yuan, or 4 per cent of SAIC-GM's 2015 sales revenues from relevant products.

Antitrust enforcement, targeting specific industries like the automotive and pharmaceutical device industries will likely continue into 2017, as Chinese authorities become increasingly sophisticated and willing to tackle larger and more complex antitrust cases.

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 approvals and filings with the competent PRC authorities depending, inter alia, on the country, region and industry of the target assets, the investment amount, and the identity and ownership structure of the Chinese investor. The Chinese outbound investment approvals and filings are not applicable nor available to Chinese individual investors.

NDRC regulates Chinese companies' outbound investment activities on a project-by-project basis through a multi-layered approval and filing regime. A Chinese investor is required to make a filing with NDRC's local counterpart and obtain an NDRC filing
notice for an outbound investment transaction with a size of Chinese investment below US$1 billion that does not involve a ‘sensitive country or region’ (countries and regions that are sanctioned, subject to war or civil commotion, or have no diplomatic relations with the PRC) or a ‘sensitive industry’ (such as basic telecommunication, cross-border hydro-resources development, large-scale land development, main electricity transmission line and grid, and media). If a transaction is of a size of above US$1 billion, or 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 central NDRC (or an approval from the State Council in cases of a transaction of a size of above US$2 billion and involving a ‘sensitive country or region’ or a ‘sensitive industry’). In addition, if the size of a Chinese outbound investment reaches or exceeds US$300 million, the Chinese investor is required to submit a project information report to NDRC before signing a definitive purchase agreement, submitting a binding offer or bid or submitting applications with foreign governmental authorities, and central NDRC will grant a project confirmation letter after its review as a ‘green light’ to allow the Chinese investor to continue pursuing the potential transaction. Such NDRC project confirmation letter is a pre-condition for a Chinese investor to enter into a definitive purchase agreement with a foreign seller, or submit a binding offer or bid in an auction or bidding process.

MOFCOM regulates Chinese companies’ outbound investment activities from industry and trading perspectives. A Chinese investor is required to make a filing with the provincial MOFCOM and obtain a certificate of outbound investment for an outbound investment that does not involve a ‘sensitive country or region’ or a ‘sensitive industry.’ If a 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 central MOFCOM.

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, NDRC and MOFCOM approvals and filings, and even registration with the State Administration of Foreign Exchange (SAFE) as described below, may not be required by the parties as closing conditions (although the Chinese buyer may nevertheless go through the process to obtain NDRC and MOFCOM approvals and filings for them to be able to repatriate funds from the relevant investment back to China in the future).

After obtaining NDRC and MOFCOM approvals and filings, a foreign exchange registration with SAFE through a local Chinese bank is required for currency conversion and remittance of the purchase price out of China. However, this will not be applicable if the Chinese investor uses offshore capital to fund the transaction. A foreign exchange registration would also be required in the case of an earnest deposit to be paid from China to overseas immediately upon, or within a short period of time from, 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. Such registration can be handled by a local Chinese bank if the amount of the deposit does not exceed US$3 million or 15 per cent of
the purchase price and concurrently with the NDRC project confirmation process. Payment of deposits of higher amounts needs to be approved by SAFE on a case-by-case basis after completing the NDRC project confirmation process.

A Chinese SOE 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 stockholder approval before closing and make necessary disclosures required by the Chinese securities exchange rules.

Since late 2016, it has been reported that the increasing flow of Chinese outbound investment activities has become a source of concern to Chinese authorities, which have adopted more stringent control and supervision of outbound investment activities and capital flow. In an official press release dated 6 December 2016, the central governmental authorities, including NDRC, MOFCOM and SAFE, in their response to a media inquiry on tightened scrutiny of outbound investment transactions, said that they had been alerted to some irrational outbound investment activities in real estate, hotels, film studios, the entertainment industry and sports clubs, and potential risks associated with overseas investment projects involving:

a. large investments in businesses that are not related to the core businesses of the Chinese investors;

b. outbound investment made by limited partnerships;

c. investments in offshore targets that have an asset value larger than the Chinese acquirers;

d. projects that have very short investment periods; and

e. Chinese onshore funds participating in the going-private of offshore-listed China-based companies.

The tightened control on outbound investment activities and capital flow not only affect Chinese investors, but also are relevant to international private equity players from at least two perspectives: when a private equity player intends to partner with a Chinese investor in an M&A outside of China, or when a private equity player is considering a Chinese buyer for a trade sale as its exit route. In these scenarios, the private equity investor needs to 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.

**Foreign investment approvals**

The US, the EU and countries scrutinise or regulate international business activities, including relevant Chinese outbound investment activities, to achieve national security, foreign investment control, and competition law and other objectives. In connection with Chinese investors’ investing in or acquiring target assets in the US or EU Member States, the relevant parties should be aware of potential foreign approvals that may be mandatory or necessary in the jurisdiction where the target is located depending on the nature and size of the transactions, which may include US and EU merger control review and Committee on Foreign Investment in the United States (CFIUS) review. A CFIUS review is often perceived by parties to Chinese outbound investments as one of the major foreign regulatory hurdles.

CFIUS is an inter-agency committee of the US government that is empowered to review transactions that result in control of a US business by a non-US person to evaluate whether such transactions may create a national security risk. CFIUS establishes the process for reviewing the national security impact of foreign investments, joint ventures and other
investments into US-located businesses, and CFIUS analyses a broad range of national security factors to evaluate whether a transaction may create a national security risk to the US. Although the CFIUS notification process is voluntary, transactions not voluntarily notified to CFIUS may be investigated or even unwound post-closing. Therefore, parties to transactions that involve Chinese buyers often need to assess whether the proposed transaction could raise national security concerns and potential CFIUS risks, and be prepared to develop and execute parallel workplans to address concerns of CFIUS and other interested parties. CFIUS risks are highlighted by some recent Chinese outbound investment transactions abandoned or terminated due to CFIUS issues, including:

- 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;
- 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;
- termination in February 2016 of the proposed investment in Western Digital by Unis Union and Unisplendour after CFIUS determined to investigate the transaction; and

III YEAR IN REVIEW

i Recent deal activity

Going-private transactions

The trend of US-listed Chinese companies going private heated up in 2015 and continued in 2016. Based on statistics obtained through searches on Thomson ONE, during 2014, eight US-listed going-private transactions were announced and 17 were closed; during 2015, 25 US-listed going-private transactions were announced and six were closed; and during 2016, 15 US-listed going-private transactions were announced and 18 were closed.

The struggle by some Chinese companies against market research firms and short sellers has often provided interesting perspectives on the environment faced by Chinese companies listed in the US. Market research firms, and short sellers such as Muddy Waters Research and Citron Research, building on their successes in past years, continued to target Chinese companies listed in the United States in 2016 by issuing critical research reports. The business model of such firms appears to be issuing negative research reports on a public company while simultaneously taking a short position in the company’s stock, which often enables such firm 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),16 which are commonly considered to have lower

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16 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) through which process 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 and fulfilled the burdensome disclosure requirements of an IPO.
profiles and to be more prone to disclosure issues. 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 on its website a scathing report on New Oriental Education & Technology Group Inc, sinking the company’s share price to US$9.5 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 US and went public in a traditional IPO. The company’s stock price subsequently recovered to US$13.90 a month and a half after the Muddy Waters report came out, suggesting the market’s belief that the accusations were not justified. From 2011 to 2012, Citron Research, Anonymous Analytics and certain other short-selling organisations and individuals have issued a series of reports that portrayed Qihoo’s business and financial position as overvalued and fraudulent, which were rebutted by Qihoo and which proved to be fruitless attacks resulting in little impact on the share price of Qihoo, suggesting that investors in the US market could remain rational when facing this type of short-selling attempt. 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’s share price experienced substantial recovery during Q4 2013 and Q1 2014, but has lost more than 80 per cent in value amid continued attacks by Muddy Waters, and currently trades at around one-sixth of its 2013 high.

Regardless of the ultimate outcome, the fact that a single research report could inflict so much substantial and sudden damage to a company’s 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 has afforded a few firms that have conducted on-the-ground research outsized influence in the market. Further, such critical coverage, which often involves allegation of disclosure issues or even fraud, have 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 into, and charges imposed against, US-listed China MediaExpress and its chair and CEO for fraudulently misrepresenting its 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 Muddy Waters initiated coverage of its investigation into fraud by, and issued negative reports against, these companies from 2010. 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 remained depressed from 2013 to 2016. Further, even Chinese companies relatively free of negative coverage often felt that their business model and potential are not fully appreciated in 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-earnings ratio (P/E ratio) of 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 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 greater than those offered in the US.

The disparity in valuation levels and perceived receptiveness naturally present 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 announced and signed during 2015 was the proposed acquisition of Qihoo 360 Technology Co Ltd by a consortium consisting of its co-founder and chair, Hongyi Zhou, its co-founder and president, Xiangdong Qi and certain other investors, in a transaction valuing the NYSE-listed company at approximately US$9.3 billion (not taking into account 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 tend to have smoother processes, some more recent transactions of this type went through more eventful processes, suggesting increased challenges in completing such transactions in a more competitive deal-making environment with a shrinking pool of desirable targets. 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 shareholder 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 drawn 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 have since engaged in an intense publicity war, and despite the fact that iKang’s board adopted a poison pill in an apparent attempt to thwart Meinian’s bid, Meinian increased its offer price for a 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 and the buyer group led by Meinian determined and notified iKang to withdraw their go-private proposals involving iKang.

The going-private trend was not limited to entities resulting from an RTO; 12 of the 15 US-listed China-based companies that announced receipt of a going-private proposal in 2016, for example, were Cayman Islands companies (and one was a British Virgin Islands company) that accessed the public markets through a conventional IPO, compared with 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. 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 stronger and less likely to have accounting or securities law compliance issues, and thus more likely to grab a higher valuation in the future.

A majority of US-listed China-based companies involved in going-private transactions in recent years are incorporated in the Cayman Islands. This was driven in part by the introduction of new merger legislation in the Cayman Islands in April 2011, which made statutory mergers 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, absent any higher threshold in the articles of association of the target company. The lower approval threshold makes it an attractive option when compared with either a ‘squeeze out’ following a takeover offer, which would require the buyer consortium to obtain support from 90 per cent of the shareholders, or a scheme of arrangement, which would add time and costs arising from the court-driven process.

Most of the transactions that closed in 2016 took between two and four months from the conclusion of definitive agreements to close (the rest typically took five months or longer from such time to close) 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 the other basic 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 ‘going-private’ transactions as defined under Rule 13e-3 of the Securities and Exchange Act, also commonly referred to as ‘13e-3 transactions.’ A 13e-3 transaction requires making additional disclosures to the public shareholders, including as to the buyer’s position on the fairness of the transaction. An important implication is that, whereas the SEC reviews only a fraction of all proxy statements, it routinely reviews 13e-3 transactions, which can lengthen the process by several months. Companies incorporated outside the United States and listed on US stock exchanges (including the recent going-private targets that often are incorporated in the Cayman Islands or the British Virgin Islands) are known as foreign private issuers (FPIs). FPIs are not subject to the proxy rules, but they are subject to 13e-3 disclosure obligations and are required to include as an exhibit to their 13e-3 filings most of the information that is required to be disclosed in a proxy statement by a US domestic issuer. Accordingly, both a transaction involving a US domestic company and a 13e-3 transaction involving an FPI follow a comparable timetable for the 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 deter or have deterred the speed of going-private of offshore listed China based companies. 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.
Other notable transactions

Consolidations in the vying internet and technology industry in China has been soaring and hitting headlines since 2015. 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. 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 its largest shareholder, 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, movie 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$1.56 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.

Another noteworthy theme from 2013 to 2016 was 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 theme 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, which became 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 the 21 per cent stake for close to US$700 million.

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 finance debt.

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) 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, Entic 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 as a 
popular 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 transactions 
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 deal 
structure.

Another emerging theme in these offshore financing structures is that borrowers 
are seeking to access liquidity from the US debt markets in respect of what are essentially 
aquisitions of Chinese-based businesses – including as a means for a take-out for bridge 
financing originated out of Asia.

### iii Key terms of recent control transactions

#### Deal terms in going-private transactions

Most of the Chinese going-private transactions have involved all-cash consideration. Among 
the US-listed going-private transactions that closed during 2016, the per-share acquisition 
price represented an average premium of 25.6 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 (typically 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. 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 or British Virgin Islands companies were reported to the public in 2015, 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 is ‘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. Special committees often insist on a higher approval threshold, however, because under Delaware law, the burden of proving that a going-private transaction is ‘entirely fair’ to the unaffiliated shareholders 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 shareholder meeting.

Another key negotiation point is whether the target would benefit from a go-shop period, which is a period following signing of the 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 (through, for example, 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, such investor’s pro rata share of the remaining proceeds based on the number of shares it owns on an as-converted basis. Because there is no well-defined ‘marker’ when it comes to transaction terms in Chinese growth equity deals (unlike in going-private transactions), however, 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 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 founder(or founders) or original shareholders at onshore level without consideration or with nominal consideration, so as to justify adjusted valuation of the target company following the failure to achieve target operating results. In Chinese growth equity investments, the parties’ respective 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 more recent transactions, 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 the competition by 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 of 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 of 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 2016, the parties took an average of four months from the announcement of the going-private proposal to reach definitive agreement, and a further four 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 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 shareholder 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 a definitive agreement to close, substantially longer than what typically is required of the SEC review and shareholder approval processes, due to, *inter alia*, changes in the composition of the buyer consortium after signing. The going-private of Qihoo and Xueda Education also each took more than seven months from the signing of a definitive agreement to close, reportedly due to the procedures required to obtain outbound investment regulatory approvals or 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 commitment 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 factors 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 delisting from the US 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 re-list in the domestic market. Giant Interactive achieved a 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 re-listed on the A-share market.

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 a Series A financing of the company in 2015, raised US$1.4 billion in its listing on NYSE in October 2016, ranking as the largest IPO by a Chinese company in the US in 2016, and second-largest after Alibaba for US IPOs of China companies in history.

Another recent highlight for private equity-backed IPOs was the debut of China Huarong Asset Management Co, Ltd, which ranked as the third-largest offering in Hong Kong in 2015, with a value of around US$2.3 billion and with a suite of pre-IPO strategic investors including China Life Insurance (Group) Company, Warburg Pincus, CITIC Securities International Company Limited, Khazanah Nasional Berhad, China International Capital Corporation Limited, COFCO, Fosun International Ltd and Goldman Sachs, following the acquisition of a 21 per cent equity interest in China Huarong by these investors, which closed in August 2014.

Also noteworthy is the IPO of Beijing Bao Feng 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 variable interest entity (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.
Finally, another recent highlight in exits via a trade sale is the sale by two funds affiliated with China International Capital Corporation of their 32 per cent equity interest in Jiangyin Tianjiang Pharmaceutical Co, Ltd, China’s largest manufacturer of concentrated traditional Chinese medicine granules, to Hong Kong-listed China Traditional Chinese Medicine Co Limited in a transaction announced in January 2015 and completed in October 2015, which valued the target at over US$1.5 billion.

IV REGULATORY DEVELOPMENTS

i 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 PRC 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 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 JV interest and designation of third-party management; and
d establishment of enterprises invested 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) (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. Such 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.

NDRC and MOFCOM have clarified that the new record-filing regime does not change the current regulatory approval regimes applicable to:
a foreign investments (either greenfield investments or through an M&A, irrespective of investment amount) in a restricted or prohibited sector under the Foreign Investment Catalogue, or an encouraged sector where there are restrictions on the foreign equity ratio or the identity of senior management under the Foreign Investment Catalogue;
b any acquisition of domestic enterprises (non-FIEs) in the PRC by foreign investors, which shall be subject to the M&A Rules; and
foreign investors’ investment in listed companies, which shall be subject to the Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors.

ii Negative List market entry system
On 19 October 2015, the State Council of the PRC 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 was later introduced to pilot FTZs in Guangdong, Fujian and Tianjin. Implementation of a Negative List approach is also provided under the Draft FIL. According to this Opinion, the Negative List regime is scheduled to be trialed in certain areas (announced to be Tianjin, Shanghai, Fujian and Guangdong) from 1 December 2015 to 31 December 2017, and to be officially rolled out nationwide from 2018. NDRC and MOFCOM are taking the lead in drafting the Negative List and the determination of trial areas. The Negative List will mainly include a market access negative list and a foreign investment negative list. The market access negative list will be a control measure equally applicable to domestic and foreign investors, and will set out the same requirements for market access management purposes for all business operators. The foreign investment negative list will apply to foreign investors’ investment and operation activities in China, and act as special control measure targeting market access by foreign investment.

On 2 March 2016, NDRC and MOFCOM jointly issued the Draft Negative List for Market Access (Trial Version). The Draft Negative List contains 232 ‘restricted’ (i.e., subject to approval) and 96 ‘prohibited’ items, and these items were partly compiled from existing laws, regulations and administrative catalogues, and also include new restrictive or prohibitive measures (for example, an approval requirement for collaborations between domestic media and foreign news agencies, and a content censorship requirement for gaming and entertainment equipment prior to sale of the same in China). The measures specified in the Draft Negative List will apply to both Chinese and foreign investors. This Draft Negative List is pilot-run in Tianjin, Shanghai, Fujian and Guangdong.

iii Expansion of areas and new regulatory regime for pilot FTZs
On 28 December 2014, the Standing Committee of the National People’s Congress promulgated new rules to establish pilot FTZs in Guangdong, Tianjin and Fujian, and to expand the area of the current China (Shanghai) Pilot Free Trade Zone. 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:

- FIE formation; extension of FIE operation term;
- division, merger or other material changes for WFOE;
- dissolution of an EJV;
- material changes to joint venture contracts and articles of association for a CJV; and
- transfer 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 8 April 2015, the General Office of State Council of the PRC issued the Special Administrative Measures for Foreign Investment Access in Pilot Free Trade Zones (FTZ
Negative List) applicable to the four FTZs, which took effect 30 days following the date of issuance. Such FTZ Negative List, subject to adjustment as appropriate by the authorities, contains industry-specific measures and uniform measures applicable to all industries. Foreign investment in FTZs in industry sectors other than those specified in the FTZ Negative List will be administered in accordance with the principle of equal treatment of domestic and foreign investors, and the relevant FIEs can be established by a company-registration procedure with no foreign investment approvals required.

On 8 April 2015, central MOFCOM issued the Administrative Measures for the Record-filing of Foreign Investment in Free Trade Zones (for Trial Implementation) (FTZ Record-filing Measures), which took effect 30 days following the date of issuance. Where a foreign investor makes an investment in a sector other than those specified in the FTZ Negative List, the record-filing of the incorporation, as well as subsequent changes of a foreign-invested enterprise and its joint venture contract and articles of association, shall be subject to the FTZ Record-filing Measures. The FTZ Record-filing Measures underscore that, where a foreign investor is to incorporate an enterprise in FTZs engaging in a business not in the FTZ Negative List and subject to the record-filing regime, the foreign investor shall, after having obtained the corporate name clearance, log onto an online one-stop FTZ platform to submit a filing application either before the implementation of investment (i.e., issuance of business licence for incorporating a new FIE) or within 30 days of the implementation of the investment. The filing authority will scrutinise whether the matter submitted should be subject to filings, and if they decide that it should be, the authority should complete the filing formality within three business days.

On 25 August 2015, central MOFCOM issued Shang Zi Fa [2015] No. 313, an opinion on supporting the innovative development of FTZs (Circular 313) with immediate effect. Circular 313 relaxes the requirements for FIEs in FTZs to engage in the direct selling business, and allows foreign investors to establish foreign-invested pawn enterprises and WFOEs for the construction and operation of gas stations in FTZs.

On 19 July 2016, the State Council of the PRC published the Decision on Provisional Adjustment of Administrative Rules and Regulations in Pilot Free Trade Zones (Circular 41). Based on Circular 41, among other changes, in designated FTZs (which may include the expanded area of Shanghai FTZ in respect of certain changes), certain restrictions on foreign investments (including restrictions on foreign shareholding ratios or full foreign ownership) set forth in the Foreign Investment Catalogue and other existing regulations are temporarily lifted in the following sectors:

- exploration and development of oil and natural gas (including oil shale, oil sand, shale gas, coal bed methane and other non-conventional oil resources);
- usage of mining gas;
- processing of edible oils from soybean, rapeseed, peanut, cottonseed, tea seed, sunflower seed, and palm;
- manufacturing of biofuels (ethanol and biodiesel);
- manufacturing of motorcycles;
- manufacturing of certain rail equipment;
- construction and operation of gas stations;
- construction and operation of comprehensive water-conservancy hubs;
- manufacturing and R&D of electronic equipment for autos;
- manufacturing of energy storage batteries for new energy vehicles;
- steel production;
selection and breeding of new types of agricultural goods and production of seeds;
purchase of grain, wholesale of grain and cotton, and establishment of large-scale agricultural wholesale markets;
accreditation and certification agencies;
air cargo sales agencies, warehousing, ground services and food services;
performance (entertainment) agent companies;
marine shipping brokers, marine shipping services and management services;
printing published materials; and
entertainment centres.

iv PRC Cybersecurity Law
On 7 November 2016, the Standing Committee of the National People’s Congress of the PRC passed the PRC Cybersecurity Law, which will take effect on 1 June 2017. The Law applies to all data transmitted and stored in networks within the PRC. The Law sets forth broad restrictions for cross-border data transfers, and specifies administrative and criminal liabilities (including penalties on foreign cyber attackers). One of the most significant provisions in the Law is the defined scope of network operators of ‘critical information infrastructure’ (CII), which covers information infrastructure used in public communications and information services, energy, transportation, water conservancy, finance, public services and e-government, and any infrastructure that, if it were to be destroyed, lose functionality or suffer a data leakage, may cause a material threat to national security, the social or economic wellbeing of the nation, or the public interest. The Law sets a high standard for cybersecurity protection obligations of CII operators.

Among other regulatory requirements, all personal and important data collected and stored by CII operators are required to be stored onshore subject to certain PRC localisation requirements, and restricted from cross-border transfers without proper security assessment and clearance; and if any purchase of network products or services may have an impact on national security, CII operators are required to pass certain national security reviews conducted by cybersecurity authorities.

V OUTLOOK
In light of increased scrutiny by regulators in both the US and China, foreign private equity investors in China continue to increase their focus on rigorous pre-transaction anticorruption 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.

We expect several key factors to impact the level of deal-making activities in 2017 as compared to 2016. One key theme of the region going into 2017 is to what extent and in what sectors and geographical regions China will maintain its economic growth. As China continues to manage a ‘soft-landing’ and to restructure its economy, certain investors may find new opportunities, while other investors may shy away from deal making due to increased uncertainty and a less rosy outlook. The regulatory landscape is also a key factor that would impact investment patterns. The regulators’ tightened scrutiny of outbound investments may have the effect of slowing down Chinese outbound M&A, and bring some financial investors’ focus and interest back to the PRC domestic markets. Another related factor is the trend
of yuan devaluation, and the government's currency policies and efforts in stabilising the exchange rate of the yuan and related capital outflow. A continued slowdown of the economy or further devaluation of the currency, or both, may further change the market's expectation regarding the value of the yuan, and needs to be taken into account in the evaluation of investment opportunities in the region for the short to mid-term. Exits via IPO for private equity investors may present challenges given the difficulties in accessing domestic A-share listings, and exits via trade sales or secondary sales may continue as the main exit route for a long period. Chinese banks could come to play a larger role in this type of transaction and M&A activities in the region in general given their still-strong capital position and Chinese regulators' increased familiarity with international transactions and increased willingness to approve such transactions, and as these banks accumulate more experience across the table from major international players. One final factor to flag is the increasing role played by Chinese private equity funds in regional and international deal making. They are already playing major roles in a number of recently signed or closed transactions, including Qihoo and iDreamSky, and their presence in the market is likely to further increase as a result of the development of more onshore-oriented deal structures (such as that employed in Qihoo), which would allow these funds to fully utilise their vast reserve of onshore capital, and the larger role played by onshore Chinese banks with which the Chinese funds are more familiar.

While going-privates of Chinese companies listed in the US are slowing down, in 2017 there could be increased market attention on going-privates or takeovers of Chinese companies listed on the Hong Kong Stock Exchange. Two remarkable transactions heading the trend of the going-private of Hong Kong-listed companies are 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 joint offerers 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, 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.
Chapter 7

COLOMBIA

Hernando A Padilla and Giselle Herrera

I OVERVIEW

By May 2016, a total number of 90 private equity funds (PEFs) had been incorporated in Colombia,2 67 of which had already concluded their fundraising stage. As of 2016, a total of US$21.93 billion has been raised in capital commitments by 83 of these funds,3 in comparison to a total of US$ 924 million raised by the total number of PEFs in place prior to 2010.4

Closed funds to date have targeted their investments towards a wide range of industries, namely infrastructure (nine), real estate (14), natural resources (two), venture capital (VC) (four), social and environmental impact initiatives (six) and multisector PE (23).5 Investments in multisector PE initiatives are highly diversified, as target companies operate, inter alia, in the financial, health, retail, entertainment, technology, manufacture, transportation, tourism, education, food, agriculture, utilities, mining and construction industries.

i Deal activity

During 2016, Colombia was ranked by the Latin American Venture Capital Association (LAVCA) as the third most dynamic Latin American PE/VC market in terms of number of deals, surpassed only by Brazil and Mexico and reporting a total of US$415 million invested through 18 transactions in industries as diverse as, inter alia, transportation, financial services and information technology.6

By way of example, in 2014 Darby Private Equity, through its Colombian-based Fondo de Infraestructura en Transporte FINTRA, acquired a 5 per cent minority interest and transportation rights in Oleoducto Central SA (Ocensa), Colombia’s largest oil pipeline, for US$385 million.

On the other hand, IFC Asset Management Company invested US$80 million in Pacific Midstream, a major oil and gas market player in Colombia, with a view to bolster domestic energy infrastructure.

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1 Hernando A Padilla is a partner and Giselle Herrera is an associate at Philippi Prietocarrizosa Ferrero DU & Uría.
3 Ibid., p. 33.
In late 2014, Victoria Capital Partners acquired a significant percentage of Grupo Corona, a major Colombian industrial organisation, to finance the organisation’s growth and development of industrial business units in the region.

During the 2014–2015 period, Advent Latin America Private Equity Fund VI invested in nine different Latin American companies. Target highlights include:

a. Alianza Fiduciaria, the largest independent asset and trust manager in Colombia;

b. Alianza Valores, a leading independent Colombian stock broker-dealer;

c. Cataratas do Iguaçu, the largest concessionaire and operator of natural parks in Brazil; and

d. Lifemiles BV, one of the largest and fastest-growing frequent flier miles programmes in Latin America.7

On the other hand, real estate PEFs Inverlink Estructuras Inmobiliarias and Terranum Capital Latin America Real Estate Fund I concluded significant investments in several real estate projects during the 2014–2015 period, with Terranum finalising its investment stage.

In 2016, Ashmore concluded significant investments in Termo Mechero Morros and Elecnorte, two Colombian companies dedicated to electric power generation.

Notwithstanding the breadth and depth of multisector PEF initiatives in Colombia, recent trends in PE transactions, coupled with several governmental initiatives and legal developments on the matter, point to a growing focus on infrastructure projects. Such trends have been welcomed and followed by several fund formation initiatives. For example, Sura Asset Management and Credicorp Capital set up an infrastructure-focused PEF – FCP 4G Credicorp Capital Sura Asset Management – which seeks to raise US$400 million to be invested in road infrastructure projects in Colombia. Notable investors include local pension funds and insurance companies.

In 2016, Ashmore Group, through its Colombian-based Fondo de Deuda Senior para Infraestructura en Colombia CAF-AM Ashmore I, invested in two senior syndicated loans, for US$116.46 million in the aggregate, for the financing of toll road infrastructure projects Concesión Costera Cartagena Barranquilla and Concesión Transversal del Sisga.

Furthermore, CFC-SK El Dorado Latam Fund LP acquired a 10 per cent minority interest in Concesionaria Vial del Pacífico, a toll road infrastructure concessionaire, for US$20 million.

ii 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 governing general partners’ (GPs’) remuneration in private placement memoranda, and on the terms and conditions of engagement of such GPs with the relevant funds. Therefore, a correlation between carried interest arrangements and duration of trade sales and buyouts is hard to establish.

7 Bancóldex, footnote 4, p. 8.
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 forth in such 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 in order for such 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 of time.9

All CIFs, including PEFs, must be administered by qualified institutions under the surveillance of the Colombian Superintendency 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 such custodians with all information required for the adequate performance of their custodian 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 Capital Markets Self-Regulating Entity);
- design, approve and execute corporate governance policies required in connection with PEF administration duties;
- exercise all voting rights attached to the portfolio securities under their administration; and
- 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 the SFC’s surveillance 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

9 However, a PEF’s private placement memorandum may also set forth special terms and conditions governing early or partial redemption of LPs’ participation units.
10 These institutions are also referred to collectively as CIF administrators in the event that the relevant CIF is not a PEF.
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 need not be regulated institutions under the SFC’s surveillance. This regulatory distinction between GPs and external portfolio managers is justified by the nature of PEFs’ investments (at least two-thirds of the funds being invested in unregistered securities). A GP’s non-regulated nature is further offset by the appointment of a PEF’s surveillance committee in charge of overseeing performance of the GP’s 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 forth 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 set forth 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 in the event that such company’s decision-making power is subject, whether directly or indirectly, to the will of one or more third parties that will be considered 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;
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

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; 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 supermajorities provided for by law, as in the case of stock corporations, or otherwise set forth 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 such GP in Colombia for all legal purposes. Should a foreign GP acquire participation units in the PEF in which it has been appointed as a portfolio manager, such GP must register its foreign portfolio investment before the Colombian Central Bank by completing and filing FX 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 in a portfolio company's board of directors will be deemed to be managers under Law 222. Such directors owe several fiduciary duties to the portfolio company and its shareholders.

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11 The PEF, and not the PEF administrator or the GP, will appear in the portfolio company's mercantile registry as such company's controlling shareholder, as set forth by the SFC in Concepto 2012101056-001 dated 14 January 2013.
12 These supermajorities 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.
13 The relevant provisions of Law 222 regarding directors' liability and other corporate matters have been incorporated into the Colombian Commercial Code.
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 such 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 such 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 damages 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 damages, 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 following approval of such filing by the shareholders’ meeting, the company’s statutory auditor or any other company director may enforce such claim.

Likewise, the company’s creditors may also exercise the corporate responsibility suit against directors, provided, however, that such 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 of 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 under Section I, supra, it is worth mentioning that buyouts and growth financing remain the most popular PE/VC investment strategies in Latin America.\(^{14}\) Colombia’s recent deal activity is a clear example of this.

Further, available data for 2015 reveals that growth equity investments (seven, amounting to US$288 million in the aggregate) are significantly higher than buyout transactions (two, amounting to US$95 million in the aggregate).\(^{15}\) Recent regulatory reforms calling for mandatory third-party valuations of portfolios by external consultants,\(^{16}\) coupled with a strong perception of currency volatility, political instability, and a cumbersome regulatory and tax environment in the region,\(^{17}\) might help explain the overall preference for growth-financing transactions. Financially sound companies that are deemed to be well settled in their relevant markets and reporting stable cash flows are thus viewed by GPs as a safer investment strategy.

ii Financing

The most common financing schemes for PE/VC transactions include leveraged buyouts and syndicated loans.

For example, Darby Private Equity’s acquisition of a minority stake in and transportation rights from Ocensa was made possible by way of a credit agreement with Banco Itaú Nassau Branch. Collateral over the purchaser’s shares was granted in favour of Banco Itaú, and escrow accounts were established to further guarantee debt repayment.

Other notable examples include a syndicated loan granted by Banco Itaú Nassau Branch and Banco Davivienda in favour of Terranum to finance its acquisition of Decameron Hotels & Resorts; a syndicated loan granted in favour of Altra Investments, Mercantil Colpatria and SCL Energia Activa to finance their joint acquisition of Termodavla SA ESP; and a syndicated loan 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 for entities under the SFC’s surveillance to finance the acquisition of a controlling stake in a portfolio company with funds received from the general public (clients), and the prohibition incumbent upon commercial banks to facilitate loans aimed at acquiring a majority interest in an entity under the SFC’s surveillance.

\(^{14}\) LAVCA and Coller Capital, footnote 8, p. 6.
\(^{15}\) LAVCA, footnote 6, p. 20.
\(^{17}\) LAVCA and Coller Capital, footnote 8, p. 4.
iii Key terms of recent control transactions
In January 2016, a consortium led by Canadian-based Brookfield Asset Management Inc acquired Colombia’s controlling stake (57.6 per cent) in power generator Isagen SA (Isagen) for US$2 billion. Representing the largest privatisation in Colombia’s recent history, the proceeds of the sale will be allocated to investments in the country’s ambitious fourth generation (4G) infrastructure projects, encompassing, inter alia, highways, bridges, toll roads and tunnels.

iv Exits
Colombia reported the third-largest number of exits in Latin America (five) during 2015, generating proceeds for US$300 million.18 Recent notable exits in 2014 and 2015 include the following.19

Advent Latin America Private Equity Fund VI divested four of its portfolio investments in Latin American companies Atmósfera, Monte de México, Kroton and Cetip.

Fondo de Capital Privado por Compartimentos CP-Val liquidated its compartment (sub-fund) Compartimento CP-Val Eléctrico Colgener.

Fondo de Capital Privado Hidrocarburos de Colombia I, II and III concluded exits for all of its portfolio investments. Distribution of profits arising from the projects’ cash flows and the proceeds of the sale transactions amounted to US$524.9 million, compared to an initial investment of US$292 million. The gross internal rate of return (IRR) of all three phases of the fund was 26 per cent, while the aggregate net IRR was 17 per cent.

Tribeca reported several exits of its portfolio investments during 2014 and 2015. During the third quarter of 2014, it divested its portfolio investment in Sociedad Portuaria El Cayao, in charge of the construction and operation of the first liquefied natural gas regasification terminal in Colombia, currently under construction on the outskirts of Cartagena. Sale proceeds resulted in a 1.4x gross equity multiplier and a 20 per cent gross IRR.

During the first quarter of 2015, Tribeca Fondo TC Dorado reported its divestiture of OTCA, the Bogotá El Dorado Airport cargo terminal operator. This exit took place five years after the fund’s initial investment, and resulted in a 1.8x gross equity multiplier and a 23 per cent gross IRR.

During the second quarter of 2015, Tribeca Energy Fund reported its exit of Termocandelaria Power Limited (TPL), the fifth-largest electricity generator in Colombia in terms of installed capacity. The sale of Tribeca’s stake in TPL resulted in a 2.2x gross equity multiplier and a 17 per cent gross IRR.

During the second quarter of 2015, Tribeca reported the sale of its investment in Bogotá Beer Company, Colombia’s largest craft brewer and pub operator. This exit took place only two years following the fund’s initial investment, and resulted in a 1.8x gross equity multiplier and a gross IRR of more than 30 per cent. Tribeca’s aggregate exits via its multiple funds have entailed a distribution of US$457 million to LPs, amounting to 1.1x of their total capital commitments and positioning Tribeca’s distribution of investment returns as one of the largest among Colombian PEFs.

18 LAVCA, footnote 6, p. 9.
19 Bancóldex, footnote 4, pp. 8–10.
During 2016, Aureos Latin America Fund reported the sale of its investment in Koba International Group SA, a company that operates a hard discount supermarket chain called D1, to the PE fund manager Capital Group Private Markets.

Fondo de Capital Privado Hidrocarburos de Colombia Fase I, Fase II and Fase III divested all of its portfolio investments. Distribution of profits amounted to US$486 million, compared to an initial investment of US$185 million.

IV REGULATORY DEVELOPMENTS

In terms of regulatory oversight, PEF administrators are subject to the permanent surveillance of 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 Financial System's Organisational Statute), and further comply with their PEF administration duties in the terms set forth 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 before the SFC. For such registration to take place, the PEF administrator must file the PEF’s private placement memorandum and other supporting documents before the SFC for the latter to provide its comments or objections, if any, in due course. In the absence of 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 (ID) to the relevant fund. Following such resolution, the fund will be ready to start its operations, which will at all times be subject to the provisions of such 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 857 of 2011, whereby the MHCP amended certain provisions of Decree 2555 governing pension funds’ investment regime, including the types and amounts of permitted investments per type of pension fund and asset class, and applicable corporate governance rules;

b Decree 816 of 2014, whereby the MHCP facilitated investments by institutional investors in domestic PEFs whose investment policies focused on infrastructure projects undertaken by public-private partnerships (PPPs) governed by Law 1508 of 2012, subject to the government’s participation in the relevant target projects;
c Decree 1385 of 2015, aimed at increasing investments to finance public infrastructure projects undertaken by PPPs, with the purpose of permitting investment in PEFs whose investment policies are focused on assets and securities issued, owned or secured by institutional investors or any of their related parties;

d Decree 1403 of 2015, whereby the MHCP amended certain provisions of Decree 2555 to allow PEFs to invest up to 100 per cent of LPs’ capital commitments in real estate assets without becoming real estate CIFs; and

e Decree 765 of 2016, whereby the 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;20 and
- modify investment caps and requirements for currently admissible assets, especially for investment vehicles incorporated by foreign issuers.

V OUTLOOK

While the investment landscape in Colombia remains dynamic, a comprehensive look ahead at PE/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.21 Considering the government’s continuing initiatives to raise and allocate resources (including the proceeds of Isagen’s recent sale) to the development of 4G infrastructure projects, Colombia is no exception to this regional trend.

While approximately one-third of LPs have recently invested in new GPs’ debut Latin American-focused funds following the 2008 global financial crisis,22 the scarcity of established GPs is still seen as the biggest deterrent to new investors in Latin America.23 Perceptions about exit barriers, regulatory burdens, currency fluctuations and the imminence of future tax reforms may further jeopardise LPs’ willingness to invest in Colombian-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.24 A special focus on reforms to pension funds’ investment regimes so as to adapt to international practices and industry standards is particularly noteworthy in this regard. Successful regulatory developments in this area may significantly enhance fundraising strategies.

20 The category of restricted assets includes hedge funds and investment vehicles in which more than 10 per cent of the underlying assets are high-yield securities.
21 LAVCA and Coller Capital, footnote 8, p. 9.
22 Ibid., p. 9.
23 Ibid., p. 4.
24 LAVCA, footnote 16, p. 12.
Finally, the strong devaluation of the Colombian peso against the US dollar\textsuperscript{25} may trigger foreign GPs' interest in the region and encourage them to inject their capital commitments into Colombian portfolio companies.

\textsuperscript{25} The representative market foreign exchange rate (TRM) has nearly doubled the average TRM for the third and fourth quarters of 2014.
Overview

Deal activity

The French private equity sector recently has been recovering, and has benefited from several favourable factors. The uncertainties arising out of the tax policy of the government following François Hollande’s election as President in 2012 have disappeared, and the availability of financing sources associated with a positive global outlook have generally benefited the private equity sector in France over the past couple of years.

Nevertheless, 2016 raised doubts and uncertainty, resulting in some investors greater exercising caution regarding Europe. It is still hard to quantify the effects of Brexit on European private equity transactions; however, the incursion of major global funds in France slightly decreased during the past year. Their absence might be a result of the lack of large-cap deals. Large-cap buyouts have been rare recently in France (only nine transactions above €1 billion over the past four years). The mid-cap segment was the most dynamic during the past year, while the small cap market has tended to shrink.

The aggregate number of LBO transactions stands at 279 for 2016, valued at €8.8 billion, against 236 in 2015, 219 in 2014 and 180 in 2013, which corresponded to the lowest year in the cycle.

The private equity industry has also been very active in terms of build-up transactions. Indeed, during the first half of 2016, French private equity firms invested €5.5 billion to support and accelerate company growth projects. This figure was up 47 per cent relative to the first half of 2015, and is above 2006 to 2008 annual average, which confirms the strong recovery that began in 2014.

Regarding sale processes, the general trend is towards longer duration, less competition and an increase in bilateral transactions in lieu of auctions.

Operation of the market

Management equity incentive arrangements

Management packages in the French market tend to be quite similar to those existing in other markets, but have certain specificities. Management is most of the time offered the
opportunity to participate in transactions through one or several special purpose vehicles (management companies). The level of financial involvement will be personal for each manager, and will depend on whether the target group has already been acquired under a LBO and whether the manager is reinvesting his or her proceeds.

Stock options plans can also be proposed, although amendments to the tax legislation have reduced the incentive to set up such plans. In a nutshell, the gain derived by the beneficiaries from the exercise of the options (as opposed to the gain upon disposal of the shares, if any) is now treated as remuneration for income tax purposes (i.e., with no tax advantage compared with a mere bonus scheme). Under certain conditions, these plans remain an efficient alternative as far as social contributions are concerned.

In 2016, it became quite usual for strategic actors to offer a management package to the management teams of a target. For instance, Imerys and the Bel group, among many others, adopted this method to respectively purchase Kerneos from Astorg and Materne Mont Blanc from LBO France4.

Following recent changes (Finance Act for 2017), the favourable tax regime of qualified free shares plans has been amended, making the implementation of such plans less favourable than before. Changes include notably:

a the acquisition gain is subject to capital gains tax treatment (with allowances up to 85 per cent depending on the length of the holding period) only for an annual amount of gain of €300,000 per beneficiary, meaning that the excess portion of the gain over €300,000 is now treated as remuneration for income tax purposes (i.e., with no tax advantage compared with a mere bonus scheme). In addition, such excess portion will be subject to the specific 10 per cent contribution (similarly to the acquisition gain on stock options plans, and as applicable from 2012 to 2015).

b the tax liability of the company granting the ‘free shares’ has been increased from 20 to 30 per cent (as applicable from 2012 to 2015).

Despite these adjustments, the use of such plans to structure management packages can still be considered if properly structured.

Under qualified free shares plans, it is in principle possible to issue preferred shares or ordinary shares. However, qualified free shares plans do not fit all situations of management equity incentive arrangements.

Managers may invest on a pari passu basis with the financial sponsor, which means that they are invited to invest through the same securities as the financial sponsor (i.e., shares, bonds, convertible bonds or other financial instruments). Should this be the case, the managers will receive the same return as the financial sponsor.

To reinforce management’s involvement in the transaction, financial sponsors most of the time offer managers the opportunity, subject to conditions, to achieve a higher investment return than their own return. To achieve this goal, the managers can invest in shares only, whereas financial sponsors invest in shares and interest-bearing debt instruments. In such a case, the risk profile for the managers is higher than a financial sponsor’s, since debt instruments and interest accrued on such debt are senior to share capital. On the other hand, if the global investment return exceeds the hurdle of interest accrued on the debt instruments, the equity advantage of the managers is higher than that of the financial sponsors.

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In addition, or alternatively, the managers can invest in preferred equity instruments (e.g., preferred shares), the return of which is higher than ordinary shares but contingent on a certain level of global return (e.g., internal revenue rate or multiple achieved by the financial sponsors).

From a tax standpoint, it is crucial that the managers act and be treated as ordinary co-investors, which implies in particular that their investment be material and at risk. Indeed, if not the case, this would significantly increase the risk that the French authorities try and recharacterise the gain recognised by the managers at exit into a remuneration treated as such for tax and social charges purposes. In this respect, it is important to note that management packages have lately been under a high degree of scrutiny by the French authorities, who have set up a specialised unit to examine them.5

Legislative changes over the past few years have impacted on the tax environment of management packages, including the amendment of the tax regime of capital gains on securities. Such gains are now subject to individual income tax at a progressive rate (together with social taxes, up to 62 per cent) with, under certain conditions, a progressive allowance depending on the length of the holding period; and amendments to individual equity schemes (PEAs), according to which preferred shares and stock warrants are no longer eligible for PEAs.

Sales process

There is no specific duration for a sale process in France, as many different factors may influence the duration. The first factor depends on whether the sellers want to prepare vendor due diligence reports, which has become more and more frequent in auction processes in France, even for mid-cap transactions. The preparation of a comprehensive set of due diligence reports (finance, legal, tax, strategic, environmental, etc.) can take up to two or three months, depending on the thoroughness of the reports and the availability of management. Once the process is launched, the due diligence exercise for a standard transaction usually varies between six and eight weeks, which is followed by the negotiation of the share purchase agreement and the signing of the transaction. Assuming no specific regulatory clearance outside antitrust clearance is required and that only antitrust clearance in France is necessary (as opposed to EU antitrust clearance), the closing of the transaction can be anticipated at the latest 25 business days after the filing is carried out, provided that the transaction does not raise any specific issues from an antitrust perspective (Phase I).6 In the end, once the decision to start a process is made, the target can in theory be transferred within six to nine months. At the beginning of 2016, the market was seller-friendly. Sellers’ demands required flexibility from bidders in regards of both certainty of completion and pricing. Managers have also had an important part to play in the final choice among bidders, especially in secondary and tertiary buyouts in which they hold significant capital share.

In practice, the general trend regarding sale processes that has been observed in France over the past few years is an increased duration and less stringent competition. Valuation gaps

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5 Since January 2015, the French Tax Authorities (FTA) publish on their website the schemes that they consider to be abusive, among which are unconventional incentive schemes. This reflects the FTA’s determination to fight abusive management packages. The FTA may feel encouraged by a decision of the Supreme Court dated 26 September 2014.

6 In the event that the transaction raises antitrust issues, the duration of a Phase II process in France is up to 65 business days; see Section IV, infra.
between buyers and sellers remained significant, resulting in many processes being postponed or cancelled after rounds of negotiations. More and more transactions were carried out without recourse to an auction process and were the result of direct negotiations between the parties on the basis of unsolicited offers.

In that respect, and as it was for 2015, 2016 stood out regarding the return on the French market of ‘hot’ assets (i.e., mature assets on promising markets), for which competition among private equity players was fierce. This resulted in their level of risk adversity being significantly reduced and marked the return of pre-emptive offers, limited due diligence and share purchase agreements entered into with little to no representations and warranties. It should, however, be stated that this only applied to a limited number of assets, and the general trend described above remained accurate for most others.

As a consequence, sellers still tend to carefully review the opportunity to launch auction processes, as the risk of going through such process is to jeopardise the value of the asset if the auction process turns out to be less successful than expected, hampering an exit for the financial sponsor for a certain period of time following the failed process. Such risk is mitigated in the case of a direct negotiation between the sellers and one purchaser if confidentiality is respected. The drawback lies in negotiations being longer than expected, as momentum can be more difficult to gather on a straight one-to-one negotiation than on the occasion of an auction process.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

When structuring a private equity transaction, the joint investors and future shareholders of the acquisition vehicle (i.e., the sponsor, the managers, any minority shareholders or mezzanine lenders) will need to determine the rules that will apply to them in their capacity as security holders of such vehicle.

These rules, which mainly relate to corporate governance matters and security transfers, are generally set out in a shareholders’ agreement and reiterated to a certain extent in the acquisition vehicle’s by-laws, especially if incorporated in France under the form of a société par actions simplifiée, which offers great flexibility to tailor its by-laws to the shareholders’ needs.

The main reason for such duplication is that the breach of some of the provisions of the by-laws can result in compulsory enforcement of the breached undertaking, whereas the breach of a security holders’ undertaking under a shareholders’ agreement can generally only result in damages. However, as the by-laws of the acquisition vehicle must be filed with the commercial court register and are therefore public, private equity players generally decide to reproduce in the by-laws only those rules provided in the shareholders’ agreement that they do not consider confidential.

ii Corporate governance rules

The corporate governance rules usually relate to the organisation of the group companies’ management bodies and to the level of financial reporting that will be granted to the sponsor on a regular basis throughout its investment. To limit its exposure to legal liability with regard to the management of the group, the sponsor’s role in the acquisition vehicle is generally of a restricted nature and limited to exerting its rights as a shareholder, without interfering with the management of the company, which remains the prerogative of the management team.
However, the sponsor is generally represented in the acquisition vehicle through corporate bodies deprived of any day-to-day management powers (such as supervisory boards), the role of which mainly consists in supervising the management of the company and authorising some extraordinary management decisions that are listed in a limited manner in its by-laws or in the shareholders’ agreement (e.g., obtaining new bank loans, realising external growth acquisitions and issuing new securities). In addition, and unless the sponsor is a minority shareholder in the transaction, it will in all circumstances retain the power to dismiss all or part of the members of the corporate bodies, including the managers.

iii Share transfer rules

The rules relating to the transfer of securities are well established in France and generally include the following:

a standstill undertakings from all security holders (or from at least the managers) under which they undertake not to transfer their securities for a certain period of time;

b right of first refusal allowing a security holder to acquire the securities of another security holder if the latter wants to transfer them to a third party or another security holder pursuant to a bona fide offer;

c tag-along right allowing a security holder to sell its securities at the same time and under the same conditions as another security holders if the latter wish to transfer them to a third party or another security holder pursuant to a bona fide offer; and

d drag-along right allowing one or several security holders representing a certain percentage of the share capital to force all the other security holders to sell their securities if they wish to sell the group.

In addition, the shareholders’ agreement will usually include a set of rules to organise an exit, including the provision of triggering events, rules relating to the appointment of an investment bank to conduct the sale or IPO process, provisions in relation to the pricing of the securities issued by the acquisition vehicle, and whether representations and warranties shall be granted in the context of an exit.

Whether the sponsor’s investment is of a controlling nature or consists of the acquisition of a minority interest will have an impact on the rights it will be entitled to in the by-laws or the shareholders’ agreement. The main considerations with respect to a minority shareholding will be to secure the sponsor’s investment by providing anti-dilution clauses, having the possibility to trigger an exit and, as the case may be, being granted certain veto rights within the supervisory board with respect to extraordinary management decisions.

iv Fiduciary duties and liabilities

Fiduciary duties and liabilities of the sponsor’s representatives

As stated above, sponsors in private equity transactions are usually represented within the acquisition vehicle through corporate bodies deprived of day-to-day management powers, which role mainly consists of supervising the managers, and authorising in advance some management decisions that are listed in a limited manner in the by-laws or the shareholders’ agreement of the acquisition vehicle.

Should they comply with their statutory powers, members of a supervisory board would not face any of the civil or criminal sanctions to which the executive managers may be liable in the case of mismanagement of the company. They could only be held liable for acts or omissions committed in the exercise of their duty to supervise the management
bodies, and failure to disclose to the shareholders any mismanagement committed by the managers of which they would have been aware. In addition, insurance policies are generally subscribed by the acquisition vehicle to protect the members of its supervisory board against civil liability.

However, members of a supervisory board could face the same civil and criminal sanctions as those reserved for the executive managers if they were to exceed their statutory powers and hold, in fact, an effective role in the management of the acquisition vehicle (i.e., becoming a de facto director). In the absence of a specific definition of such concept provided for by French law, the courts’ decisions refer to indications that prove, in fact, that a person has been performing the acts or duties of a de jure director.

Under French law, a de facto director faces the same liability as any other de jure director, without benefiting from the rights and privileges attached to such mandate. Principally, these are that in the case of mismanagement, the de facto director could suffer personal bankruptcy or a prohibition from managing other commercial companies or, most importantly, could be held financially liable for the company’s debts that are due to insufficiency of assets resulting from such mismanagement. Second, in the case of legal violations or mistakes made by the de facto director, the provisions of the French Commercial Code relating to the criminal liability of directors are applicable to the de facto director. Third, a recent case law development shows that a parent company that has acted as the de facto director of its subsidiary might, under certain circumstances, be considered as the co-employer of the subsidiaries’ employees, and thus might be jointly responsible for its labour obligations.

**Fiduciary duties and liabilities of the sponsor itself**

As a shareholder, the sponsor is not subject to any fiduciary duties or liabilities, as its role mainly consists of securing its investment within the acquisition vehicle in accordance with its by-laws, without interfering in the day-to-day management of the group. In addition, as French acquisition vehicles are usually structured as limited liability companies, which set up a corporate veil between the shareholders and the acquisition vehicle’s investments and liabilities, the sponsor’s financial liability is limited to the amount of its initial contribution.

However, should the sponsor’s role within the acquisition vehicle exceed that of a normal shareholder, it might face the risk of being considered as a de facto director, with the same consequences as those described above. It is therefore important to reserve to the acquisition vehicle’s de jure directors the exclusivity of the management and the implementation of the commercial strategy of the group. To do so, the role of each party has to be clearly identified and separated. As such:

a) the role of the shareholder, within the general assembly or through a supervisory board, has to be limited to the protection of its investment. In addition to the legally reserved matters, the list of decisions that require the prior approval of the shareholder should be limited to the major and exceptional decisions that might have an impact on the value of the investment;

b) specific subcommittees might be created by the supervisory board to ensure scrutiny of the managers on some specific matters such as reporting, and the drafting of the annual budget and the investment plan. The members of such subcommittees can be appointed from within the investment team (whether or not such members are in the supervisory board) or externally. The role of these subcommittees should be limited to recommendations given to the managers, who should feel free to follow them or not; and
whenever the management requires further involvement from the investment team members to assist them on specific matters, such assistance should be limited to a specific period of time and be provided by the investment team members not as representatives of the shareholder, nor as members of subcommittees, but as service providers acting as a third party. This business relationship is governed by a service agreement and the service provider is paid for the services requested by the management.

III YEAR IN REVIEW

i Recent deal activity

The vitality of the French private equity industry relies more on small and mid-cap transactions than on large-cap transactions. Large-cap transactions remain rare in France.

Only one transaction exceeded the €1 billion threshold in 2016: Foncia (real estate – €1.8 billion) compared with four transactions in 2015: Verralia (packaging – €3 billion), Linxens (smart cards connectors – €1.5 billion), Labco (medical diagnostics – €1.2 billion) and Webhelp (call centres – €1 billion). The lack of large deals throughout 2016 resulted in strong competition between the local mid-market funds. PAI purchased B&B Hotels (announced in 2015 but closed in 2016) along with pharmaceutical company Ethypharm, valued at €750 million, Astorg was revealed as the successful bidder for Parkeon with an estimated value of €450 million, and Bpifrance has been very active in the mid to large-cap sector, with 12 deals and more than €300 million put to work (including the purchase of 8 per cent of the shares held in the Les Petits Chaperons Rouges group alongside Eurazeo).

Capital development appears to also be a dynamic sector of the French private equity market, according to Grant Thornton and the AFIC, the French Association of Investors for Growth. In late June 2016, this segment saw a progression of investments of 25 per cent over the year, after a previous increase of 66 per cent during the first semester of 2014.

Regarding sale processes, and except as stated above, the general trend is longer duration, less competition and an increase in bilateral transactions in lieu of auctions. As an example, Tractel was sold by Cinven to LBO France in a few weeks. In this context, private equity players face fierce competition, which results in increased valuation for targets (for instance, Linxens was valued by CVC on the basis of a 11.5 x multiple).

ii Recent amendments to tax legislation impacting LBO transactions

In the recent years, the French parliament introduced a number of anti-abuse mechanisms and limitations on the deductibility of interest, especially on related party loans.

Despite these new restrictions, it is fair to say that the French tax consolidation regime, which allows the offset of the transaction costs and financial charges incurred by the acquisition vehicle against the operation profits of the target group, still creates a favourable (and competitive, compared to other jurisdictions) tax environment for LBO transactions. It is worth noting in this respect that the Finance Act for 2017 has introduced a progressive decrease (from 2017 to 2020) of the standard corporate income rate from 33.33 per cent to 28 per cent. On the contrary, EU Directive No. 2016/1164 of 12 July 2016 notably...

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8 See footnote 2.
9 Le capital-développement se démarge dans le private equity français, A Laurin, Agefi, 16 October 2015
prescribes that EU Member States implement in their respective corporate tax systems (before 1 January 2024) an interest deduction limitation rule according to which the deductible net interest expenses would be limited to 30 per cent of the taxpayer’s EBITDA. Member States may choose to allow taxpayers to deduct exceeding borrowing costs in excess of 30 per cent of EBITDA, but only up to €3 million. The interest limitation rule provides for an optional grandfathering clause, allowing Member States to exclude loans that were concluded before 17 June 2016 from the scope of this new rule. In addition, the Directive provides for a number of safe harbour rules. Compared to other jurisdictions, the impact of the Directive on the French private equity market is quite uncertain considering the existing anti-abuse mechanisms and limitations on the deductibility of interest, but implementation discussions should be carefully monitored to amend acquisition structures as may be necessary.

Following a decision rendered by the Court of Justice of the European Union (CJEU) in Steria,10 the Amended Finance Act for 2015 introduced some changes to the tax treatment of certain dividend distributions to be received by French companies.

For fiscal years starting on or after 1 January 2016, dividends distributed within a French tax consolidated group are subject to tax for a portion of 1 per cent only (i.e., 99 per cent exempt from tax, hence an effective rate of taxation of 0.34 per cent). Similarly, distributions received by a French parent company member of a tax consolidated group from a subsidiary established in a state belonging to the European Union (EU) or the European Economic Area (EEA) that would have met the conditions to be a member of the tax group to which the parent company belongs if it had been established in France are 99 per cent exempt.

iii Financing

The trend observed during the past few years remains the same (i.e., the decrease of the global share occupied by traditional banks in financings, except for upper mid-cap and large deals). Such a trend is the result of various factors: changes recently made to French banking monopoly rules broadening the type of entities able to lend to a French borrower; constraints imposed on banks by Basel III rules; and the increasing presence on the market of many senior debt funds, some of them now real players with a serious track record in financings.

The French banking monopoly rules are set out in the French Monetary and Financial Code, and prohibit entities other than authorised institutions from carrying out credit operations in France on a regular basis. As a consequence, the granting of loans to a borrower located in France (i.e., a French entity or the French branch of a foreign entity) and the purchase of non-matured loans from an entity located in France (i.e., a French entity or the French branch of a foreign entity) constitute credit operations that fall within the scope of the banking monopoly rules. Although there are more and more exceptions to these mandatory rules, it is vital when structuring a financing package in France to check that no member of the lender pool is in breach of the French banking monopoly rules. Although the Supreme Court has ruled that a loan made available in breach of the French banking monopoly was not automatically void, it failed to give clear guidance regarding the applicable criteria for potential voidance, and there is still a risk of imprisonment, a fine, or both.

The banking monopoly rules have always had a key impact in France when structuring, for instance, a mezzanine or ‘unitranche’ financing package for a French acquisition vehicle. If the mezzanine or unitranche lenders (at the time of funding the acquisition) are not authorised

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10 CJEU, 2 September 2015, No. C-386/14, Groupe Steria SCA.
credit institutions under the relevant French or European regulations, it is not possible to structure the mezzanine or unitranche financing under the form of a credit facility. This is the key reason why mezzanine, second lien and unitranche financings in France are mostly construed under the form of warranted or warrantless (more and more warrantless, actually) mezzanine bonds (i.e., bonds issued by the French acquisition vehicle and subscribed for by the mezzanine or unitranche debt providers), since the debt providers of such type of financings are in general not traditional banks. There is one subject of concern, in France and abroad: what will be the consequences of the implementation of Brexit on the possibility for UK banks to lend directly in France? Unfortunately, nobody knows at this stage.

Because bonds issued by a French company are securities governed by certain French corporate law rules, the process of obtaining, for example, a waiver from the bondholders will differ from the process that applies to the senior pool of lenders. Approval of the waiver request is obtained by a decision of a bondholders’ meeting convened for such purpose. In practice, for the waiver request to be approved by such creditors, it is insufficient to obtain the countersignature of the waiver request by the bondholders’ representative, as is the case for the senior agent after obtaining the relevant majority from the syndicate members. In relation to bonds issued by a French company, the majority rule for any changes to the terms and conditions of such bonds is, under the law and with very few exceptions, set at two-thirds.

As a consequence, even though structuring a financing via bonds can be at first glance a bit more complicated, these financings are well known now by market players in France, and are chosen in many transactions.

Due to the high number of debt funds acting in France and the fact that traditional banks are also still major players, sponsors have a real advantage in terms of pricing because of very strong competition among all the debt providers. It should, however, be remembered that some of these debt funds are funds specialised in distressed situations, and it is in a group’s interest to think about the pros and cons of letting such institutions lend to it. In the eventuality that a group one day faces financial difficulties, it may be more dangerous dealing with such creditors rather than a usual bank syndicate (which, almost by definition, is very slow in terms of decision-making and, at least in relation to French banks, very reluctant to become a shareholder).

It is worth mentioning a feature specific to France when raising an external debt financing via bond issues at the level of a French newco where part of the equity of the sponsor is construed (as is the generally the case) partially through convertible bonds. The French insolvency rules contain some provisions that have a direct impact on the usual subordination principles, the key one being that the acquisition of external debt will be senior to the subordinated debt injected by investors. In the event of an administration order being placed on the French newco or the newco entering receivership, in accordance with the relevant provisions of the Commercial Code, and provided some criteria defined by French law are met, an extraordinary general meeting of all bondholders shall be convened to vote on the proposed restructuring plan. Note that in a French bondholders’ assembly, as the vote requires the support of two-thirds of the bondholders, it will be crucial for external creditors to ensure that subordinated creditors are not able to impose conditions (such as debt-to-equity swap and debt abandonment). Therefore, some mechanisms have emerged in the French market, usually dealt with in the intercreditor agreement, to contractually organise such a situation (conversion of a certain portion of convertible bonds by the sponsors or a temporary sale of convertible bonds to the senior bondholders, call option and reverse
Another structuring solution exists to avoid such a situation (but is more complex and expensive): creating a French topco above the French newco and placing the subordinated debt injected by the investors at the level of French topco.

It should be noted in relation to bond financings that an important number of high-yield bonds issues have occurred over the past few years (even though this particular market is much less active currently than it was in 2014–2015). Because of the complexity of the documentation, the costs and the time to organise this type of financing, it is really applicable only to large-cap deals when a very significant amount of financing is necessary (these bonds are usually governed by New York law and are listed).

Apart from these evolutions in terms of types of financings, it is useful to note some principles regarding security packages in France. One crucial detail of French law is that a security interest may be enforced only if the secured obligations are due and payable, meaning that a provision stating that the agent may enforce the security interest in the case of occurrence of an event of default is invalid under French law. The trigger event for enforcement of any kind of French-law security interest, usually defined as an ‘enforcement event’, is generally written as follows: ‘Enforcement event’ means any failure to pay on its due date any secured obligations or the service of any notice of acceleration in accordance with [clause X (acceleration and cancellation) of the [credit agreement/terms and conditions of the bonds]].

This typical French rule, because of the French insolvency rule pursuant to which it is no longer possible to enforce against a French entity the security interests granted by it if it becomes insolvent, had led to ‘double luxco structures’. The key objective for lenders had been to construct a security package that would enable to them to enforce their security interests without being prevented from doing so by, for instance, safeguard proceedings opened at the level of the French borrower. These structures, which are very complicated and expensive, are not at all adapted to the mid-market arena, and in the large-cap world, it should be kept in mind that it is not certain at all that such structures would really be positive for the lenders (let alone all the tax and corporate governance questions it may raise for the sponsors when structuring the deal, the life of the deal and the exit). The trend we observed last year has been confirmed: these double luxco structures are certainly no longer as popular as they once had been.

It is also interesting to note that there is no concept of partial enforcement in France; in general, the beneficiaries of a French pledge have no real economic interest in enforcing the French-law security interest in the event of a simple default on interest payments, and indeed, if they decide to enforce the security interest, the enforcement proceeds to which they will be entitled will be limited to the amount of the unpaid interest, so they have no more security interest securing the principal amount of the secured obligations if the latter has not previously been declared immediately due and payable through the acceleration process provided for in the facilities agreement.

Finally, it should also be noted that a security package cannot be properly construed without taking into account some specific French tax rules; indeed, depending on who is the grantor of security interests (related party or not), and the type of guarantee or security interests granted, part of the secured debt could fall under certain limitations of deductibility of debt at the level of the French borrower.
iv Key terms of recent control transactions

French practice has evolved since the Lehman crisis as regards transaction terms, even though there are still some particularities applicable for French private equity transactions. Needless to say, share purchase agreements (SPAs) are more frequently discussed now than during the pre-Lehman boom years when purchasers sometimes just executed a seller’s first draft SPA without negotiating the terms. Those days are long gone for most transactions, but the three main items looked for by private equity sellers remain the same: deal certainty, representations and warranties, and purchase price mechanics. On deal certainty, material adverse change clauses tend to be used less frequently in French private equity transactions than they are in the US, for instance, but are more and more frequently being requested by potential purchasers. Representations and warranties still tend to be very limited in French private equity transactions: industrial players have not modified their practice to ask for wide representations and warranties. The scope of representations and warranties obviously depends on how competitive the process is, and sometimes private equity players grant specific representations and warranties on certain precise and identified issues. Should this be the case, a portion of the purchase price may be put into an escrow account because, once paid by the purchase price, the management company of the funds distributes the proceeds to their limited partners (LPs), which results in it being more difficult for the money to be sought after by the purchaser. Price mechanics in French private equity transactions often take the form of a locked box, but post-closing adjustment mechanisms help to reconcile the expectations of sellers relating to the purchase price and what the potential purchaser is prepared to offer in this respect. French private equity funds may prefer the certainty and simplicity of a straightforward figure they can present to their LPs over a purchase price adjustment, which may be complex and leaves the door open to being challenged.

v Exits

Increased competition among private equity players has enabled favourable conditions for exits. The AFIC evidenced a proactive exits market, reporting a total disinvestment of 695 in H1 2016, compared with 161 exits in H1 2015, due to the popularity of material size divestments. The cost of said divestments, amounting to €4.4 billion, represents a record amount: the long-term trend has moved toward more exits in excess of €100 million.\(^\text{11}\)

IV REGULATORY DEVELOPMENTS

i Foreign investment procedures

In recent years, the authorities with jurisdiction to supervise foreign investments in France have tended to be more present on the market, and have not hesitated to contact foreign investors or their advisers to verify that they are aware of the obligations imposed on them by French law.

Such obligations consist of a prior notification to the French Ministry of Economy, Finance and Industry (MEFI) in almost all cases where the acquisition is led by a foreign investor; and a notification to the Bank of France after completion of the transaction, mainly when the amount of the investment is in excess of €15 million.

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\(^{11}\) Grant Thornton and the French Association of Investors for Growth, press release, 13 October 2016.
In addition, in some limited areas of the French economy deemed sensitive for national security considerations (mainly gambling, private security, research of antidotes, interception and certification of information technologies, and the defence sector, as well as, since 2014, activities relating to the supply of water, electricity, gas, hydrocarbon or other energy sources, and activities relating to public health), the prior authorisation of the MEFI will be required. In such case, the foreign investment review will be led by the MEFI, which, in determining whether to approve or to deny the investment, may seek input from various other ministries, including the Ministry of Defence and the Ministry of the Interior.

When it is deemed necessary, the MEFI may condition its authorisation on specific commitments from the foreign investor, such as the fulfilment of ongoing contracts or obligations of the target, or the maintenance of its long-term operations. Failure on the part of the foreign investor to agree to such conditions may cause the application for investment to be denied. If accepted, the ministry having jurisdiction over the relevant industry will oversee the enforcement of such commitments by the foreign investor.

The MEFI has two months from the submission of a complete application by the foreign investor to complete its review and respond to a request. In the event of failure to do so, the transaction will be deemed approved. Any agreement enforced before such decision is rendered will be deemed null and void. In addition, criminal and civil penalties may be pronounced against the foreign investor.

ii Merger control procedures

The French Competition Authority (FCA) issued revised merger guidelines in July 2013 based on the experience it had acquired during the past four years. These new guidelines aim to improve merger-control procedures at various levels. The guidelines first emphasise the importance of the pre-notification phase enabling both the parties and the FCA to hold informal discussions before the formal notification so as to anticipate and address competition issues.

The FCA has further clarified the eligibility criteria to benefit from a simplified procedure. From now on, where the parties are not active on the same markets (upstream, downstream or related markets), or where the transaction involves acquisitions of retail stores without a brand change, a simplified decision may be obtained within 15 working days. From a substantive stance, the FCA has also clarified the applicable conceptual framework and the role of the analysis of relevant markets, notably in the food processing and supermarket sectors. In the same line, the former annex on the submission of economic studies has been revised and replaced by a general guide to mergers. Finally, where either the parties or the FCA consider adopting structural remedies such as divestures, the guidelines provide templates for the transfer of assets and trustee mandates. These templates provide basic guarantees and can be adjusted on a case-by-case basis.

V OUTLOOK

The French private equity market currently faces some areas of doubt. On the one hand, the Chinese slowdown, the petrol crisis and the situation in the Middle East, instability in South America, recurring threats to leave the European Union, currency changes, Brexit, and

12 Decree No. 2014-479 dated 14 May 2014 relating to foreign investments subject to prior authorisation.
presidential elections in major countries, including France, have created strong uncertainty in stock exchanges that might affect the recovery of French private equity. On the other, private equity investors may wish to benefit from financing sources that are still available, stable French fundamentals overall and good opportunities that still exist in the French market to continue developing their activities in France. A major reform of French contract law was also passed in October 2016, which was generally well-received. Among the diverse goals of this reform is to enhance the global competitiveness of French law in comparison with other legal systems in the world.

Regardless of the pre-existing difficulties affecting the market, 2016 was still a good year for private equity operations. While it remains uncertain what will happen in 2017, some good opportunities may still be revealed for swift players. The presidential elections in 2017 are likely to lead to the return of political uncertainty in France, which in turn is likely to create a waiting period for investments in France.
Chapter 9

GERMANY

Steffen Oppenländer and Heinrich Knepper

I OVERVIEW

i Deal activity

In 2016, the German PE market thrived. Buyouts and exits reached their highest levels since 2007 in terms of number and transaction value. The private equity (PE) market's development was in line with the overall strong M&A market in Germany. Buyouts started on a solid level in 2016 and peaked in the second half with an extraordinary strong Q4 (€9,773 million). Exits on the other hand started well into 2016 and decreased in H2, mirroring the picture of 2015.2 Germany strengthened its position as one of the most attractive PE markets in Europe, second only to the UK. While deal activity was significantly above levels of previous years, it still remained considerably behind the heights of 2007.

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<thead>
<tr>
<th></th>
<th>All of 2016</th>
<th>Q1 and Q2 of 2016</th>
<th>Q3 and Q4 of 2016</th>
<th>Change between H1 and H2 2016</th>
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<tbody>
<tr>
<td>Total buyouts (€ million)</td>
<td>16,630</td>
<td>6,154</td>
<td>10,478</td>
<td>70.3%</td>
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<tr>
<td>Total exits (excluding IPOs) (€ million)</td>
<td>17,193</td>
<td>9,976</td>
<td>7,219</td>
<td>-27.6%</td>
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Source: Mergermarket

Small and mid-cap companies continue to be the primary focus of PE investors, but the number of high-value transactions saw an increase in 2016: nine deals crossed the €1 billion threshold (compared to five deals in each of 2015 and 2014) and 17 deals surpassed €500 million (compared to 13 deals in 2015 and 10 deals in 2014). These ‘mega-deal’ opportunities are highly competed for by PE investors.

In summary, German PE activity reached a post-crisis high in 2016 for both acquisitions and exits by PE investors. After several years of continued recovery and a setback in 2014, PE continues on its growth path.

PE buyouts

The overall value of PE acquisitions in Germany in 2016 reached €16.6 billion. Compared to 2015, the value increased by almost 30 per cent. The number of transactions increased from 135 in 2015 to 174 in 2016. The majority of buyout activity in 2016 can be

1 Steffen Oppenländer and Heinrich Knepper are partners at Hengeler Mueller.
attributed to a small number of high-value deals. Five transactions exceeded a volume of €1 billion (namely the €3.3 billion acquisition of OfficeFirst Immobilien by Blackstone, the €2.9 billion acquisition of Apleona GmbH by EQT, the €1.4 billion acquisition of Airbus Group’s defence electronics business by Kohlberg Kravis Roberts & Co (KKR) and the €1.0 billion acquisition of Acetow by Blackstone Group). Another four transactions surpassed the €500 million mark (namely the €925 million acquisition of KraussMaffei Technologies GmbH by ChinaChem, the €800 million acquisition of SLV GmbH by Ardian, the €700 million acquisition of Schustermann & Borsenstein GmbH by Permira Advisors and the €563 million acquisition of CHORUS Clean Energy AG by Capital Stage AG).

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<tr>
<td>Total buyouts by value (€ million)</td>
<td>22,731</td>
<td>12,050</td>
<td>14,797</td>
<td>11,565</td>
<td>12,854</td>
<td>16,630</td>
</tr>
</tbody>
</table>

Source: Mergermarket

In terms of deal value, the three most active areas were the chemicals and materials sector (€4.1 billion), the real estate sector (€3.3 billion), and the industrial products and services sector (€2.4 billion). The industrial products and services sector continues to be the most active area in terms of number of deals.

**PE exits**

The total value of exits by PE investors slightly surpassed the total value of acquisitions, with €17.2 billion of value being returned to investors as opposed to €16.6 billion of new capital being deployed. Exit values in 2016 reached their highest levels since 2007 and increased by 3 per cent compared to 2015, the previous record year.

2016 was dominated by sales to strategic investors: 70 per cent of all exits and 75 per cent of the value of exits were realised through transactions with strategic investors. Highlights include the €2.7 billion sale of BSN Medical from EQT to SCA, the €1.7 billion sale of WindMV from Blackstone to CTG, the €1.6 billion sale of WMF from KKR to Group SEB and the €1.4 billion sale of EEW from EQT to Beijing Enterprises.

Secondary buyouts, on the other hand, fell to the lowest levels since 2011. Only €4.4 billion in value was transferred from sponsor to sponsor – a drop of 50 per cent. Only two secondary buyouts came close to the €1 billion mark: the €925 million sale of KraussMaffei from Onex to ChemChina and the €800 million sale of SLV from Cinven to Ardian.

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<tr>
<td>Sales to strategic investors (€ million)</td>
<td>16,787</td>
<td>5,871</td>
<td>7,789</td>
<td>6,299</td>
<td>7,971</td>
<td>12,826</td>
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<tr>
<td>Secondary buyouts (€ million)</td>
<td>14,817</td>
<td>4,988</td>
<td>9,043</td>
<td>4,959</td>
<td>8,757</td>
<td>4,367</td>
</tr>
<tr>
<td>Total</td>
<td>31,604</td>
<td>10,859</td>
<td>16,832</td>
<td>11,258</td>
<td>16,728</td>
<td>17,193</td>
</tr>
</tbody>
</table>

Source: Mergermarket
Operation of the market

Management participation programmes

PE transactions are usually accompanied by management participation programmes (MPPs) to incentivise the management of the target company. In the majority of cases, the investor offers equity participations rather than other incentive schemes such as option plans, phantom stocks or bonus schemes. The reason for this is that, under German tax law, equity participations, if acquired by management at the outset at fair market value, are taxable only upon an exit from the investment, as opposed to options, which are taxable when initially granted. Further, the MPP is structured to create income from capital gains rather than income from employment. Investors often try to obtain binding tax rulings on certain tax issues before deciding on a certain structure. Alternatively, management may obtain a ruling by the local tax office.

Depending on the number of participating managers, an investor will typically grant shares to the management representing between 5 and 15 per cent of the capital in the aggregate. Management typically invests indirectly through a pooling company (ManCo). The ManCo is controlled by the investor to simplify the administration of the MPP, control the voting rights in the investment entity and avoid complications with managers in an exit scenario. For tax reasons, the ManCo is often set up as a limited partnership with a GmbH as general partner (GmbH & Co KG). The limited partnership is fully transparent for tax purposes. Control of the financial sponsor over the ManCo is secured through the general partner, which is typically wholly owned by the financial sponsor.

To increase the MPP incentive, the management investment is usually made exclusively or predominantly in the equity of the investment entity. By way of contrast, the PE investor invests a certain amount as equity (variable return) and the remaining funds as shareholder loans (fixed return). Thus, the management investment is leveraged compared with the investor's investment (sweet equity). If the investment performs well, the management usually gets a return per euro invested that is often four to five times the return of the PE investor (envy ratio). Sweet equity may also be provided in the form of preference shares or, if the ManCo is incorporated in Luxembourg, through preferred equity certificates or convertible preferred equity certificates.

The funding of the management investment is often facilitated by non-recourse loans extended by the financial sponsors to the management. Such loans are repayable only if and to the extent there are capital gains in the event of an exit. Loan structures, however, are scrutinised by the tax authorities with a view to meeting the fair market value test upon the grant of the investment in the ManCo. In addition, certain performance targets may exist that allow for an increase (or a decrease) of the managers’ participation upon fulfilment or non-fulfilment of certain targets (ratchets).

While the management gets a higher relative return, the investor reserves the right to decide, at its own discretion, on all capital measures, corporate restructurings and refinancings as well as on the timing and the terms of an exit. Thus, the MPP often provides for anti-dilution protection for the management, in particular if subscription rights in any capital increase are excluded and the participation of the management would be diluted by the investor subscribing for new shares.

An MPP will further contain customary tag-along and drag-along provisions (i.e., the right and, respectively, the obligation for the management to sell its shares in the case of a full or partial exit of the sponsor) as well as customary obligations of the management to cooperate in preparing the exit of the sponsor.
Dual-track structure for exits

As in 2015, major exit sales processes in 2016 were often structured as dual-track processes (i.e., the IPO preparation runs in parallel with preparations for a trade sale). Typically, the IPO track drives the timetable with a view to the limited offering windows, whereas the trade sale track is structured as a limited auction process with typically fewer bidders and a reduced scope of due diligence and Q&A.

In dual-track processes, the trade sale documentation is typically ‘secondary style’ and provides for limited bidder protection under representations and warranties and scarcely any indemnities at all. This is based on the notion that the buyer acquires a quasi-listed company instead and therefore must only rely on pre-signing due diligence. Typically the draft prospectus is made available to the potential bidders provided that they agree to a certain standstill period, varying between 12 and 18 months post-IPO. In summary, the trade sale process is mean and lean compared with a traditional sales process.

Warranty and indemnity (W&I) insurance

2016 proved to be another year of extremely seller-friendly market conditions (‘sellers’ market’). In many cases heated auction processes left little to no space for requests by bidders for any meaningful sellers’ guarantees or indemnities. Not surprisingly, 2016 saw the continued success story of W&I insurance in Germany, which had until 2014 been marketed by insurance brokers with limited success. In 2016, the majority of PE exits were combined with a ‘buyer-seller flip’ W&I insurance proposal (i.e., a W&I insurance process initiated by the seller with a view to transfer the process during the course of the negotiations to potential acquirers that can then negotiate and finalise a W&I insurance as part of their acquisition process (buyer insurance)). Such buyer insurance can cover breaches of warranties or indemnities given by either the seller or the management, and allow the relevant guarantor or guarantors to limit their own exposure to very low caps (in some cases as low as €1) – save for intentional breaches, as to which German law does not accept any exclusion or limitation of liability. Contrary to a seller insurance (i.e., insurance taken out by the seller), buyer insurance also covers intentional breaches of the seller (or, respectively, in cases of warranties issued by the management, the management team).

Despite the continued success of W&I insurance solutions in 2016, a large number of PE buyers remain sceptical regarding W&I insurance. Some fear in particular that an insurance solution may create a disincentive for sellers and their management teams to disclose all relevant matters during the due diligence, while others wonder whether the insurance will prove to be a reliable protection in the case of actual breaches of warranties or do not believe that the cost for the insurance (typically 1 to 2 per cent of the insured amount) is well invested. Given the continued success of W&I insurance in the past year, it must be expected that W&I insurance will remain an important element in the German PE M&A market.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Typically, a PE acquisition will be funded by a mixture of debt and investment capital. The precise ratio of debt to own capital has, on average, decreased from the highs reached in 2007, but as in 2015, 2016 saw levels of leverage close to the pre-crisis peaks. Leverage used in a PE acquisition is a key factor in the structure adopted for an acquisition. In particular,
a typical investment structure aims to offset the interest payments on the acquisition debt against the profits generated by the target company. This has the effect of reducing the target company's tax burden and increasing the investor’s return on its investment. To achieve this, it is common that one of the following acquisition structures is used.

A PE fund looking to invest in Germany will usually make its investment through a string of companies incorporated in Luxembourg (LuxCos) or other tax-favourable jurisdictions. Beneath the LuxCos, a German acquisition company (NewCo), or – depending on finance and tax structuring – several NewCos will be established. It is the NewCo that acquires the shares in the target company and enters into a share purchase agreement with the seller. Senior lenders will enter into a debt facility with the purchaser. Junior debt providers (such as mezzanine providers) will lend to a NewCo above the level of the purchaser, resulting in a structural debt subordination of this debt. In addition, high-yield bonds are typically also issued by a NewCo above the purchaser level.

Once the acquisition has taken place, the PE owner will look to offset its debt interest payments against the profits generated by the target company. Normally, an investor will use one of the following two options.

The first option is the establishment of a single tax entity (or tax unity). The single tax entity will encompass both the purchaser and the target company. As a result, for corporation and trade tax purposes, the purchaser and the target company will be regarded as a single entity. As a result, any tax on profits made by the target company will only be calculated after debt interest payments have been deducted. Setting up a single tax entity requires a profit pooling agreement, which again requires 75 per cent of the votes in a shareholders’ meeting. Therefore, in public-to-private acquisitions, tender offers made by financial sponsors are customarily subject to a 75 per cent threshold to be obtained in the target company. Such a condition precedent is permissible under German takeover laws.

The second option is a downstream merger of the purchaser into the target company or, alternatively, an upstream merger of the target company into the purchaser. Through the downstream or upstream merger, the purchaser and the target company become one legal entity owned by the purchaser’s parent. The obligation to pay interest on the acquisition debt is assumed by the merged entity and, for tax purposes, it can offset these payments against any profits it generates.

Irrespective of tax considerations, a merger or a profit pooling agreement (or a domination and profit pooling agreement) are also useful in view of the restrictions under German capital maintenance rules. Both the GmbH Act and the Stock Corporation Act severely restrict (Section 30 GmbH Act) or even exclude (Section 57 of the Stock Corporation Act) the grant of upstream securities (i.e., securities granted by the target to the senior bank debt providers to secure the debt facility extended to the NewCo purchaser). Such security may only be granted in the case of a target in the form of a GmbH and only subject to ‘limitation language’, meaning that upstream securities may not be enforced if the preserved equity of the target company would be reduced or diminished by enforcement, thus materially reducing the economic value of such security. However, these restrictions do not apply in the case of a profit pooling agreement (or a domination and profit pooling agreement). In the case of a merger, the entity that grants the security is identical with the debtor under the senior debt facility and, therefore, the capital maintenance related restrictions do not apply.
III YEAR IN REVIEW

i Recent deal activity

Much of the buyout activity in Germany’s PE market in 2016 can be attributed to five large transactions valued at more than €1 billion each. These included the acquisition of real estate firm Officefirst by Blackstone (€3.3 billion), the acquisition of specialty chemical firm Atotech by Carlyle (€2.9 billion), the acquisition of the building and facility division of Bilfinger SE (Apleona) by EQT (€1.4 billion), the acquisition of the defense electronics business of Airbus by KKR (€1.1 billion) and the acquisition of chemicals firm Acetow by Blackstone (€1.0 billion); certain key terms of these transactions are summarised below. The overwhelming majority of targets for PE investors continued to be small and mid-cap companies.

ii Financing

More stringent regulatory requirements for banks, especially in relation to capital and liquidity, resulting from the implementation of Basel III through CRD IV, CRR and related regulations, came into force in 2014 (subject to phase-in provisions over the following years). Contrary to what may have been expected, the actual impact of these regulatory developments on the availability of syndicated bank financings (both senior tranches and, increasingly, also second lien and sometimes mezzanine tranches), both generally and for PE investors, has been relatively limited. In particular, the increased requirements have apparently not reduced the lending capacity of banks for acquisition financings, at least where the targets were of sufficient quality. It is generally believed that this is a result of the low interest policy of the European Central Bank (ECB), combined with an asset purchase programme of a size unseen so far, which significantly increased the liquidity in the market and thus overcompensated for any restrictive effect that the new capital and liquidity requirements might otherwise have had. Contrary to widespread expectations, the ECB did not, throughout 2016, phase out or reduce its purchase programmes in the open market; nor have any significant steps been taken towards an increase of the general interest rate level, contrary also to tendencies in the United States, where the Federal Reserve has at least significantly reduced or tapered out open market purchases. In Germany in particular, these factors have been compounded by the negative real interest on German bonds, which contributed to a sustained inclination of all actors in the financial market to take risk in return for acceptable yield prospects. Competition on the syndicated lending market therefore continued to be strong.

Capital markets, in particular the high-yield bond market in Germany, have remained on a relatively low level. Only a few German-domiciled or headquartered issuers tried to tap the high-yield bond market, and some of them directly turned to the more liquid US market. Notable bond issues in 2016 included the issue by Schaeffler of a €9.5 billion corporate high-yield bond, the issue by Heidel Cement of a €752 million high-yield bond and the issue by Goren AG of an €896 million high-yield bond on the euro market.³

Another factor contributing to the weak performance of the high-yield bond markets in Germany may have been a renaissance of mezzanine financings and second lien financings, as well as the availability of debt financings from debt funds, in particular unitranche financings (see below). Nevertheless, interest by investors in high-yield bond investments has remained strong, with many issues oversubscribed, in particular for issuers with a rating at the upper end of the sub-investment grade spectrum (e.g., once again – after a successful launch in 2015 – Schaeffler issued €9.5 billion equivalent high-yield bonds in one of the largest and most widely reported transactions of this kind in September 2016).

Despite the relative slowdown in 2016, high-yield and crossover bonds documented under German law have generally proven to be a feasible option for the financing and refinancing of PE acquisitions. They have been successfully placed in the market in various instances as refinancing for German corporate issuers (such as HeidelbergCement, Continental, Phoenix Pharmahandel, KUKA), which shows their marketability. Issuers of German law high-yield bonds benefit in particular from two advantages: the documentation of the covenant package is in general shorter and less convoluted, but remains in substance the same as that for New York law bonds, which reduces the administrative effort and operational risk for the issuer significantly; and the choice of German law and the jurisdiction of the German courts mitigates the risk of expensive US litigation (in particular in Regulation S offerings, where bonds are not sold in the US). Thus, German-law high-yield bonds remain a viable alternative to New York-law bonds, and should also be increasingly considered in connection with PE deals to the extent marketability of the bonds is ensured.

Finally, there has been a modest renaissance of mezzanine and second lien acquisition financings provided by banks.

As in previous years, club deal financings (mostly by banks) were also seen as a viable option in the segment of small or mid-cap transactions. They continued to be an attractive option for smaller or mid-sized acquisition financing packages, in particular given the stronger relationship of the borrower or sponsor with the financing banks, and thus the leaner post-closing communication and administration processes.

In the current environment of readily available funds at still relatively low margins, a recapitalisation through debt refinancing continues to be an attractive option, especially where a true exit may require further preparations. Even though recapitalisations pose several challenges from a legal perspective, many successfully closed transactions have shown that these can be sufficiently solved. The increase of the leverage ratio to finance the additional cash amounts taken out by the investor require diligent review and monitoring, in particular in respect of capital maintenance rules and liquidity protection rules. A violation of these rules may result in the personal liability of the management of the group companies. As with other types of financing, the refinancing documentation would usually address these issues to a certain extent (such as in respect of the capital maintenance regime) by the insertion of ‘limitation language’ limiting the liability of subsidiaries in respect of upstream and cross-stream securities granted by them. To the extent cash is upstreamed to the investors (e.g., by way of a ‘super dividend’), however, this requires additional legal and financial analysis of available capital reserves, as well as sound and solid liquidity planning to avoid personal liability risks. Additional leeway can often be created for this purpose by group restructurings, in particular where hidden reserves can be realised. Appropriate measures should also be taken to mitigate insolvency clawback risks that may arise in respect of cash upstreamed by subsidiaries to the investors if the portfolio company becomes insolvent during a hardening period that generally lasts one year. Landmark leveraged financings of
German domiciled borrowers include a US$3.8 billion equivalent leveraged financing for ZF Friedrichshafen AG completed in July 2016, a US$2.8 billion equivalent leveraged loan for HSH Portfolio Management AÖR, the ‘bad bank’ of the public bank owned by the states of Hamburg and Schleswig-Holstein, a US$2.5 billion equivalent leveraged financing for Schaeffler, and a US$2.2 billion equivalent loan to Thyssen Krupp AG. Also widely noted was the successful completion of a US$1.1 billion leveraged refinancing in July 2016 by the INEOS subsidiary Styrolution.4

The trends in financial and legal terms outlined above illustrate that financing is available to those who can identify suitable opportunities to invest, and PE investors continue to be able to raise financings on attractive terms, especially as excess liquidity is still driven by loose monetary policy and the resulting high lending capacity. Changes in financial markets, also affecting PE acquisition finance, are certainly to be expected from Brexit as well as the change of government in the United States. Brexit, and the uncertainties in particular for the financial industry in the UK resulting from the open questions around the regulatory environment post-Brexit as well as the open question of whether decisions of UK courts will still enjoy the benefit of direct enforceability under EU regulations, are generally expected to increase the attractiveness of German-law credit documentation for financing acquisitions of German targets.

The new government of the United States has announced (if not yet implemented) significant cuts in regulations for banks, in particular a partial repeal of the Dodd-Frank legislation, which may be expected to result in an increased risk appetite of at least US banks (with a potential pull effect for European institutions).

iii Key terms of recent transactions

**Blackstone Real Estate Partners Europe IV LP/OfficeFirst Immobilien AG**

In November 2016, Blackstone Real Estate Partners Europe acquired OfficeFirst Immobilien AG, a Germany-based company engaged in office property business, from IVG Immobilien AG for an estimated consideration of €1.30 billion. The transaction is to close in the first quarter of 2017. The transaction values OfficeFirst at €3.30 billion. OfficeFirst Immobilien is one of the largest owners of office properties in the German real estate market with a portfolio of about 100 German office buildings, including the landmark The Squaire at Frankfurt airport.

**Lonestar/Xella International GmbH**

On 1 December 2016, Lonestar agreed to acquire Xella International GmbH, a leader in building solutions, from GS Capital Partners, the US-based PE firm of PAI Partners. Xella operates 96 production plants in 20 countries, employs over 5,900 employees globally and is headquartered in Germany. Xella reported revenues of €1.3 billion and EBITDA of €271 million for the past 12 months. GS Capital and PAI Partners had acquired Xella in July 2008 for a consideration of €3.2 billion. The acquisition is expected to close in H1 2017.

**KKR/Airbus**

In March 2016, companies owned by funds advised by KKR reached an agreement with Airbus Group SE to acquire its Airbus Defence Electronics Business, a leading global provider

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4 Source: Thomson One Database, All Syndicated Loans, Domicile Nation Germany, 2016.
of mission-critical sensors, integrated systems and services for premium defence and security applications based in Ulm, Germany, at an enterprise value of approximately €1.1 billion. Defence Electronics employs around 4,000 people worldwide, with annual revenues of around €1 billion. The transaction has been approved by the European Commission and is expected to complete in Q1 2017.

**KKR/GfK SE**

On 21 December 2016, Acceleratio Capital NV, a holding company controlled by funds advised by KKR, announced its intention of making a voluntary public takeover offer to the shareholders of GfK SE, Nuremberg. GfK is a Germany-based research company that provides market research services involving the regular collection of consumer data and retail audits customised to the specific requirements of clients. The offer will be structured as an all cash voluntary public tender. The offer price is €43.50 per GFK share, which represents a 29.7 per cent premium to GFK’s closing share price (€33.54) as of 7 December 2016. The offer targets the 43.5 per cent of share capital not owned by GfK’s majority shareholder, GfK-Nürnberg, Gesellschaft für Konsum-, Markt- und Absatzforschung eV (GfK Verein). On 10 February 2017, the voluntary public tender offer for GfK was successfully accepted by the shareholders. The minimum acceptance threshold of 18.54 per cent of GfK shares was reached. GfK Verein remains a major shareholder with 56.46 per cent (20,607,900 shares) of the share capital.

**EQT/SAG Vermögensverwaltung GmbH (SAG)**

On 23 December 2016, EQT entered into an agreement to sell SAG to SPIE SA. The transaction is valued at approximately €850 million. The transaction is expected to close in the end of Q1 2017. In 2008, EQT Partners had acquired SAG from Advent International Corporation. SAG provides project management, engineering, installation and maintenance services to the energy infrastructure sector with a focus on power and gas transmission and distribution. SAG has reported sales of over €1,320 million and more than 8,100 employees across Europe. SPIE strives to benefit from SAG’s complementary competences, a high-quality client base and a significantly denser geographical footprint.

**IV REGULATORY DEVELOPMENTS**

i **German Investment Code**

A new legal framework for loan funds entered into force in Germany as of 18 March 2016. In March 2015, the German Federal Financial Services Supervisory Authority, BaFin, had already issued a circular liberalising the regulatory framework governing loan funds in Germany. The German legislator seized the opportunity of the UCITS V implementation, required by 18 March 2016, to also amend the statutory framework for loan funds in Germany under the German Capital Investment Code.

The changes to the legal framework are not only relevant for German loan funds, but also for loan funds domiciled outside of Germany but extending loans to borrowers in Germany. Previously, a key obstacle for both foreign and German loan funds resulted from the wide scope of the banking privilege in Germany. Under the German Banking Act (GBA), except for narrow statutory exemptions, any lending business is subject to a licensing requirement. This applies irrespective of whether loans are granted to consumers or to corporations or other sophisticated actors. For loan funds domiciled outside of Germany, it is of particular
importance that the licensing requirement also applies to actors outside of Germany if they actively target (potential) customers in Germany to provide banking services, such as loans. Furthermore, while the mere acquisition of loan receivables generally does not necessarily qualify as regulated lending business, the restructuring of loans often already does, which made life even more difficult for loan funds.

Under the new legal framework, lending by or on behalf of funds is now regarded as part of collective portfolio management for which German fund managers are exempted from the licensing requirements under the GBA. However, German funds remain subject to investment regulatory restrictions on lending. Except for special provisions applicable to shareholder loans, loans can generally only be originated by closed-ended German ‘special funds’, i.e., funds restricted to professional investors or semi-professional investors or to both – an investor category autonomously created by the German legislator. Loans to consumers are not permitted. A single loan may not account for more than 20 per cent of the fund’s assets, and a German loan fund itself may only incur limited leverage, i.e., borrowing by the fund must not exceed 30 per cent of the fund’s aggregate or committed capital. Fund managers managing loan funds are subject to additional organisational requirements on loan processing that essentially replicate corresponding requirements applicable under German banking regulation to credit institutions.

Fund managers and investment funds domiciled in the European Economic Area (EEA) are also exempted from the licensing requirement under the GBA if extending loans forms part of their collective portfolio management activities. This makes access by EEA-domiciled loan funds to borrowers domiciled in Germany significantly easier.

For fund managers and funds domiciled outside of the EEA, the impact of the recent changes is even more limited. They only benefit from the exemption from the banking regulatory licensing requirement for lending business if the relevant fund is marketed in Germany after successful completion of a notification procedure. The relevant statutory provisions in this respect make clear that a mere notification for marketing to professional or semi-professional investors, which is easier than a notification for marketing to retail investors, is not sufficient. In practice, this implies that the vast majority of non-EEA loan funds will still not be in a position to actively offer the extension or restructuring of loans to borrowers domiciled in Germany.

ii EU Merger Regulation (EUMR)

Acquisitions involving PE firms often result in a merger filing under the EUMR. In 2016, there were 362 merger filings made under the EUMR to the European Commission (Commission), many of which involved a PE firm. Although acquisitions involving PE firms do not often raise any substantive competition concerns, the requirement to notify acquisitions and gain regulatory approval may still have a substantive impact on the timing and structure of the transaction.

Under the current regime, PE firms only need to notify a transaction and obtain clearance under the EUMR if the transaction results in the acquisition of de jure or de facto control of an undertaking, and the necessary turnover thresholds under the EUMR are met. For that reason, although a national merger filing may still be triggered (e.g., in Germany by a proposed acquisition of 25 per cent of the target entity (or even with a smaller holding in

certain circumstances)), it is not necessary to make a filing under the EUMR if a PE firm simply acquires a minority holding in an undertaking with no controlling rights, even if the turnover thresholds are met.

On 9 July 2014, the Commission issued a White Paper entitled ‘Towards more effective EU merger control’, which proposes introducing a ‘targeted transparency system’ for non-controlling stakes. Under the proposed ‘targeted transparency system’, companies would be required to submit an information notice to the Commission if the acquisition of a minority shareholding brings about a ‘competitively significant link’, which is deemed to exist if the acquisition concerns a competitor or a company in a vertically related market, and the shareholding is either around 20 per cent, or between 5 and 20 per cent but accompanied by certain factors that afford the acquirer additional influence, such as a blocking minority over certain decisions, a board seat or access to commercially sensitive information. Upon receipt of the information notice, the Commission would decide whether to investigate the transaction, in which case the company would have to submit a formal notification. For now, in view of the feedback received from stakeholders in response to its public consultation on the White Paper, the Commission appears to no longer be pursuing its proposal of a ‘targeted transparency system’ for minority shareholdings.

The White Paper also sets out a number of proposals that could help to reduce the administrative burden for companies. For example, the Commission proposes to make it easier for companies to avoid multiple national merger proceedings by asking the Commission to review transactions. The White Paper also considers affording the Commission the right to exclude transactions that normally do not raise concerns from the mandatory notification requirement under the EUMR and to apply to them the ‘targeted transparency system’. Furthermore, the White Paper proposes to exclude from the scope of the EUMR the formation of joint ventures that are located and are operating entirely outside the EEA. In late 2016, the Commission launched a public consultation to follow up on these proposals. It remains to be seen whether the proposals will be implemented. If they are, it should have the effect of reducing unnecessary costs and delays for the parties.

The increasing number of transactions in the digital sector, such as the recent acquisition of WhatsApp by Facebook, has led the Commission to reconsider whether the EUMR’s notification thresholds are sufficient to ensure that the Commission can review all deals that may have a significant impact on consumers. Under the current regime, whether a transaction is subject to review under the EUMR depends on the parties’ turnover. Transactions in the digital or pharmaceutical sectors may not meet these thresholds if they involve one or more companies that offer services for free or that do not yet achieve any sales. In its recent public consultation, the Commission floated the idea of introducing an alternative threshold for transactions that would look at the value of the transaction rather than the parties’ turnover. The consultation materials do not mention a specific euro-threshold. However, they suggest that, if the Commission were to introduce a deal size test, it would likely be combined with other criteria to ensure that the Commission only gets to review transactions that have a sufficient nexus with the EU. Interestingly, Germany will most likely introduce a value-of-transaction threshold in 2017, pursuant to which deals would have to be notified if the

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6 Paragraph 37(1) No. 3 and No. 4 of the Act Against Restraints of Competition.
consideration is valued at €400 million or more, as long as there is, broadly speaking, a sufficient nexus with Germany. It remains to be seen whether the Commission will follow suit. If so, this change could have a material impact on PE transactions.

V OUTLOOK

2016 has been a very good year for the German PE market. This was supported by a generally benign global economy, with further recovery in most EU states, an increase of growth and a decrease in unemployment in the US, and slightly recovering emerging markets. PE and PE financing were also likely further supported by the fact that, at least in Europe, the ECB has continued its extreme quantitative easing policies, resulting in an increased availability of credit.

The outlook for 2017 and beyond, in contrast, appears more unpredictable than it has been in many earlier years, primarily due to political risks and uncertainties, including the increasingly assertive and aggressive stance of the Russian government in global affairs, the implications of Brexit, which are likely to start emerging in 2017, and the expected policy changes of the US government after the election of Donald Trump, in particular associated with fears of a return of protectionist policies. Upcoming general elections in Germany, France and the Netherlands, three core EU countries, with uncertain outcomes, are likely to increase unpredictability in financial markets, including the PE and acquisition financing markets. Currently, it appears that there is no consensus amongst pundits regarding further developments in these markets, except a consensus that the likelihood of disruptive developments has increased.
I OVERVIEW

Although no official figures have been released on Greek private equity deal activity in 2016, available figures indicate that the general trends in the Greek market have been considerably lower than the overall European trends. Activities continued to decline in view of the ongoing economic meltdown in Greece.

According to the OECD, growth has rebounded in the second half of 2016 and is projected to gain strength in 2017 and 2018 as structural reforms start to bear fruit, the conclusion of a policy review with the country’s creditors raises business and consumer confidence and the economic and political environment stabilises. However, the high level of non-performing loans undermines credit growth, holding back investment, while the huge public debt undercuts confidence in the Greek economy.

Credit institutions dominate the funding of both start-ups and restructurings. However, the funding of start-ups is rather infrequent in practice. Venture capital funds typically receive funding from either credit institutions or from investors who participate in these funds and have committed to finance the purposes of the funds.

The term ‘private equity’ in Greece is used interchangeably with ‘venture capital’. The Greek venture capital market does not rely on local structures or Greek legislation. Even when funds are of Greek origin, they follow structures and arrangements that are driven by foreign jurisdictions, primarily those with tax incentives.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

A fund usually opts for ordinary shares as a form of equity interest, although preferred shares are also possible.

Preferred shares provide the following preference rights (Article 3(1) and (2), Law No. 2190/1920):

a a right related to the partial or total collection of the distributed dividend before ordinary shares;

b a right for preferential reimbursement out of the proceeds of the liquidation of the company’s assets of the capital paid up by the holders of the preferred shares;
c a fixed dividend;
d the right to participate only partially in the profits of the company;
e the collection of a specific interest;
f the right for participation, by priority, in profits deriving from a specific company activity, as set out in the articles of association; and

g full voting rights, such as with ordinary shares, or without voting rights at all or with voting rights restricted to specific issues, as prescribed in Article 3(4) of Law No. 2190/1920.

The articles of association may give specific shareholders the right to appoint board directors not exceeding one-third of their total number (Article 18(3), Law No. 2190/1920 on Sociétés Anonymes). This right must be exercised before the election of the board of directors (BOD) by the general meeting of shareholders, which only elects the remaining members of the board. Directors so appointed may be removed at any time by those having the right to appoint them and be replaced by others. In addition, on the petition of shareholders representing one-tenth of the paid-up share capital, the president of the court of first instance of the district where the seat of the company is situated may remove any appointed director for a serious cause.

The articles of association of the investee company may also prescribe that specific decisions regarding the company’s management can be taken not only by the BOD, which is the competent company body for the management of the company (Article 22(1), Law No. 2190/1920), but also by the general meeting of shareholders, which is the supreme company body (Article 33, Law No. 2190/1920). These decisions are binding on all shareholders, even if certain shareholders are absent from the meeting or disagree. It can be agreed that the consent of the investors is a necessary prerequisite for certain decisions of the BOD to be valid. However, these agreements should be part of a shareholders’ agreement, the breadth and validity of which are still to be tested under Greek case law. In any case, shareholders’ agreements cannot be integrated into a company’s articles of association. Indeed, articles of association, including corporate governance arrangements, cannot be shaped as freely and flexibly under Greek law as they can in common law jurisdictions.

The issue of ‘blocked’ registered shares whose transfer depends on the approval of the company may be stipulated in the company’s articles of association (Article 3(7), Law No. 2190/1920). A relevant approval must be granted by the BOD or the general meeting of the company. Possible restrictions to the transfer of registered shares may be either the prohibition of the transfer, if the shares have not been previously offered to the rest of the shareholders or to some of them (right of first refusal), or the designation by the company of a shareholder or third party to whom shares will be transferred if a shareholder wishes to transfer his or her shares. In either case, if such restriction is not exercised within a certain time period, the transfer of shares becomes unrestricted. Transfers of blocked shares made in breach of the provisions of the articles of association are invalid. Only the shareholder can pledge his or her own shares or put encumbrances on them. If another person, without the owner’s previous consent, pledges or transfers shares or other securities, he or she may be punished by imprisonment (Article 63a, Law No. 2190/1920).

When it comes to exit options, minority shareholders may opt for tag-along rights (that is, the contractual obligations used to protect them in the event that the majority shareholder sells his or her stake). The minority shareholders then have the right to join the transaction and sell their minority stake in the company. Minority shareholders may also use put options
(that is, option contracts giving them the right, but not the obligation, to sell a specified amount of securities at a specified price within a specified time). The enforcement of these provisions, however, may not be as smooth as in other jurisdictions. This is because court proceedings to enforce such provisions can be very time-consuming, and the Greek courts are quite unpractised at dealing with such commercial agreements.

Investors typically seek pre-emption rights in relation to any further issues of shares by an investee company. However, unless the company’s articles of association provide the contrary, these pre-emption rights are provided for in Article 13(7 to 11) of Law No. 2190/1920. In particular, in every case of an increase of share capital that is not made through a contribution in kind or the issue of bonds that are convertible to shares, a pre-emption right is granted for the full amount of the additional capital or the bond loan in favour of shareholders at the time of the issue in proportion to their participation in the existing share capital. However, the articles of association may extend this preference right to cases of increase through contributions in kind or through the issue of bonds convertible to shares. This preference right must be exercised within the term provided by the corporate body that decides the increase; that is, the general meeting or the BOD. This term cannot be shorter than 15 days from the decision on the increase. After the end of this term, shares that have not been subscribed are made available at the free discretion of the BOD. The invitation to exercise the preference right, in which the term for the exercise must be stated, is published in the Government Gazette.

**ii Fiduciary duties and liabilities**

The rights and obligations of a private equity fund as a shareholder or board member of a Greek company are the same as those applicable to other shareholders and directors. Greek corporations (called sociétés anonyme or SA companies) are managed by a BOD. The BOD is authorised to decide on any matter, act or thing pertaining to the administration, in general, of the company or to the management, in general, of the company’s property. The BOD represents the company with regard to all of its relations and dealings with third parties and performs any act pertaining to the company’s objects, with the exception only of those matters that, according to the provisions of the law, are subject to the exclusive authority of the general meeting of shareholders.

Under Greek corporate law, the duties of the BOD members are embodied by the principle of ‘fiduciary duty’, which includes:

a. the ‘duty of care’, which requires that directors make decisions with due deliberation;

b. the ‘duty of loyalty’, which requires that directors act ‘in the interest of the company’; and

c. the ‘duty of candour’, which requires that the BOD members inform shareholders of all information that is important to their evaluation of the company.

BOD members are generally considered liable in the following cases.

**Tax evasion**

The main tax evasion offences include:

a. omission of filing or filing of false income tax returns;

b. issuance and receipt of false, fictitious or falsified tax records as well as infringement of the rules contained in the tax laws;

c. non-payment of debts owed to the state; and
d VAT-associated offences.

In the case of SA companies, the BOD members of the company are principally liable. The company’s auditors may also be liable in the event that they failed to note any discrepancies.

Social security
Non-payment of social security contributions and other debts to the Social Security Fund is a criminal offence. In the case of SA companies, the chairperson of the BOD and managing director of the company is principally liable; however, usually all BOD members are sued by the Public Prosecutor.

Civil liability
Directors of SA companies may be considered liable, together with the company, for any tortious act or omission that the company committed against any third party during their management or representation of the company.

Criminal liability
Directors of SA companies, and especially the managing director (CEO), will be considered criminally liable for any criminal offences committed by the company.

Administrative liability
In some cases of administrative offences, the directors of SA companies are considered liable together with the company and may be subject to fines and penalties.

Corporate liability
BOD members are also liable as regards the company if they violate their fiduciary duty. Such BOD members’ liability regarding the company may be reduced in the case of unintentional negligent acts; and if the BOD members followed a reasonable process, took into account key relevant facts and made their decisions in good faith (‘good faith’ requires that the BOD acted without conflicts of interest and did not turn a blind eye regarding issues for which it is responsible).

In all of the above cases, the existence or absence of any liability is, of course, a question of fact that is judged by the competent court ad hoc.

III YEAR IN REVIEW

Recent deal activity
There are no available data regarding M&A transactions involving Greek companies in 2016. According to the Athens Stock Exchange,3 2016 marked the restart of primary capital draining in the country, led by the domestic bond market, while ‘off exchange transactions’ were slightly increased.

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ii Financing

Private equity-backed vehicles usually obtain financing through a traditional secured term loan facility. Non-leveraged acquisitions by private equity investors are uncommon. Instruments often used to attract equity investors include subordinated convertible bond loans and preference shares. Large acquisitions are increasingly financed through the issuance of high-yield bonds (often in combination with a traditional secured term loan facility, which may raise inter-creditor issues). In Greece, loans are syndicated either before or after the deal is done. Regarding post-closing syndication, the key issue is establishing a method of transfer of the loan that will not require any formalities or extra costs, and that will result in the new lenders being secured in exactly the same manner as if they had been the original signatories to the loan. In this respect, it should be noted that Greek material law does not recognise the common law concept of a security agent (except for financial instruments and cash). Security can thus only be vested in favour of a creditor, and each original lender needs in principle to be a party to the security agreement. In view of the above, it is largely accepted in Greece that multiple lenders benefit from a security through a parallel debt structure.

Regarding finance structuring, it should be noted that the new debt-to-equity ratios (thin capitalisation rules) and new tax provisions introduced recently will most probably have an important impact on the financing of buyout transactions. Greece now has a 3:1 debt-to-equity ratio, which is applicable to all loans provided to a company by companies related to it. Regarding taxation, a general anti-avoidance tax rule has been introduced for the first time, according to which the tax administration may disregard any artificial arrangement or series of arrangements that aim at the evasion of taxation and lead to a tax advantage. An arrangement is considered to be artificial if lacks of commercial substance. For determining if an arrangement is artificial, various characteristics are examined. For the purposes of this provision, the goal of an arrangement is to avoid taxation in the event that, regardless of the subjective intention of the taxpayer, it is contrary to the object, spirit and purpose of the tax provisions that would apply in other cases. To determine the tax advantage, the amount of tax due taking into consideration such arrangements is compared with the tax payable by the taxpayer under the same conditions in the absence of such arrangement. This provision is quite general, and it would appear that it covers any situation of structures aiming at tax efficiency.

iii Key terms of recent control transactions

While deal terms varied substantially from case to case, the following trends in share purchase agreements are prevailing:

a. purchase price adjustment clauses based on closing accounts, and a contractually agreed-upon procedure whereby disputes are submitted to an independent expert for a binding decision;

b. limited representation and warranties being given by the seller;

c. acceptance of full data room disclosure, subject to a notion of 'fair disclosure' to be agreed upon on a case-by-case basis;

d. to the extent that a regulatory approval is required, sellers insist heavily on ‘hell or high water’ clauses, whereby the purchaser undertakes to accept any condition or remedy to which the approval is subject without a termination right or the right to renegotiate part of the transaction; and

e. specific and limited material adverse change clauses.
iv Exits

In an unsuccessful company, a venture capital fund will typically seek to exercise put options and, if the investee company does not have adequate assets to allow the full exercise of a put option, make use of the personal guarantees given by the shareholders of the investee company. However, it cannot always be certain that there will be collateral security, because the personal assets of the guarantor shareholder may still, at the time the put option is exercised, be insufficient to meet the claim of the venture capital fund. Interestingly, Greek courts have not as yet dealt with the exercise of these options and their accompanying personal guarantees.

A trade sale is typically used to realise a venture capital fund’s investment in a successful company. Initial public offerings are also an option, especially if the company enjoys impressive success, yet they are inevitably less frequent in practice. Although possible, management buy-ins are quite infrequent.

The exit strategy can be built into the investment and its documentation. However, problems may occur during the application of these strategies primarily because there can be no quick remedies if a contracting party refuses, for whatever reason, to cooperate at the time of exit. Indeed, the transfer of Greek shares is complete and valid only if the tax imposed in cases of a share transfer gets paid (Article 79(4), Greek Law No. 2238/1994). If a shareholder, no matter what the contractual provisions are, does not cooperate regarding the conclusion of an exit, the transaction cannot be completed. Moreover, the commencement of proceedings, the issue of a judgment and its enforcement are all time-consuming in Greece. Crucially, the Greek courts have rarely (if ever) dealt with such cases, and it is unclear what stance they will take when asked to review exit strategies under the scope of Greek law.

IV REGULATORY DEVELOPMENTS


The AIFMD, which came into force on 22 July 2013, seeks to establish a harmonised regulatory framework for firms that manage or market alternative investment funds (AIFs) in the EU. An AIF has been defined broadly and catches a variety of non-UCIT (undertakings for collective investment in transferable securities) investment vehicles such as closed-end listed vehicles (e.g., investment trusts), and private equity, real estate and hedge funds.

The AIFMD is likely to affect most private equity fund managers who manage funds or have investors in the EU if they are identified as the alternative investment fund manager (AIFM) of a particular fund or funds. Limited grandfathering provisions apply, generally exempting closed-end funds that will end prior to 2016 or are fully invested by 2013. EU funds with non-EU managers may be required to become authorised by 2015. AIFMs managing funds below de minimis aggregate thresholds may only be subject to lighter touch requirements, which include registration with regulators, notification of investment strategies, and certain investment reporting.

Some of the significant impacts of the AIFMD are as follows:

a remuneration:

• at least 50 per cent of any variable remuneration consists of units or shares of the AIF (or equivalent);
• at least 40 per cent (in some cases 60 per cent) of the variable remuneration is deferred over a period of at least three to five years (unless the fund life cycle is shorter); and
• disclosure in an annual report of the fixed and variable remuneration of a fund, the number of beneficiaries and any carried interest paid by the fund;

\( b \) depositary:
• appointment of a depositary;
• strict liability to be assumed by the depositary for potential loss of assets under custody; and
• the depositary is required to monitor cash flows (an oversight role);

\( c \) risk management:
• functional and hierarchical separation of the risk management and portfolio management functions;
• adequate risk management systems to identify, measure, manage and monitor appropriately all risks to each private equity fund investment strategy and to which each fund may be exposed; and
• to include appropriate, documented and regularly updated due diligence processes when investing on behalf of the private equity fund; and

\( d \) transparency and reporting:
• annual report to investors; and
• reporting to the regulator (quarterly for AIFs with assets under management of over €1.5 billion).

V OUTLOOK

The M&A market in Greece is very shallow, and exit from the recession is not yet visible. The very small transaction sizes and the very few international deals indicate the climate of the market. A possible clash with the EU and the European Central Bank could eventually lead to Greece exiting the eurozone. Such a development would most likely trigger devastating effects on both the Greek economy and, presumably, the whole eurozone.
I OVERVIEW

Deal activity

Compared to other major economies, 2016 was a good year for India from a macroeconomic standpoint. The economy showed signs of resilience during a period of global uncertainty, macroeconomic parameters improved on most counts, the current account deficit stayed within manageable limits and India continued to be amongst the world’s fastest-growing economies.

The government kept its promise to make India a more attractive investment destination, passing several reforms aimed at rationalising and simplifying the process of investing and doing business in India. Although there was an overall decline in deal-making in the private equity (PE) space compared to 2015, regulatory reforms, the introduction of sophisticated enforcement mechanisms, the introduction of the National Company Law Tribunal, a booming technology sector, a stable government and a steady flow of foreign investment all helped ensure that, from an investment and deal-making perspective, 2016 continued to hit the right notes.

Over the course of the year, the government announced significant liberalisations for foreign investments. Sectors where foreign investments are now easier include financial services, asset reconstruction companies, defence, civil aviation, pharmaceuticals, private security agencies and broadcasting carriage services.

In terms of numbers, while PE investments were lower than in 2015, they continued to be higher than previous years. Estimates from public sources and market research firms put PE investments in India at around US$12.4 billion and US$16 billion for 2016, from over 965 to 1,300 deals. This represents a noticeable increase in PE activity, and has clearly broken through the US$10 billion mark over the past three years. There were many significant deals (both in terms of volume and size) seen in sectors such as technology, energy (including renewable energy), healthcare, and banking and financial services.

The technology and financial sectors were the clear winners of 2016, accounting for over US$6 billion in investments and some of the largest deal sizes. 2016 witnessed one of Blackstone group’s largest acquisitions of Mphasis Ltd for US$825 million. Canada-based PE funds were among the top investors in 2016. Notable transactions by Canada-based PE investors include Brookfield Asset Management’s US$1.61 billion investment in Towercom Infrastructure Pvt Ltd and Fairfax’s US$270 million investment in Bangalore International Airport Ltd. There has been an

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1 Nishant Parikh, Aniruddha Sen and Rohan Ghosh Roy are partners at Trilegal. The authors gratefully acknowledge the contributions of Tanaya Achar and Abhayjeet Pathania to this chapter.
overall increase in interest from Canada-based funds (including pension funds) in doing business in India. Estimates indicate that approximately US$5 billion has been invested by Canada-based funds over the past few years. Some notable investments by Canada-based funds in 2016 include Caisse de Dépôt et Placement du Québec's long-term partnership with Edelweiss Financial Services Ltd to invest approximately US$750 million in stressed assets and specialised corporate credit in India over the next few years. Other notable pension funds that have been making substantial investments over the past few years include PSP Investments and Canada Pension Plan Investment Board.

2016 saw PE exits hitting an all-time high of approximately US$6.7 billion to US$10.3 billion from approximately 199 to 239 deals. This is a marked increase from exits worth approximately US$5.2 to US$6 billion in 2015 and US$4 to US$5 billion in 2014. Exits in 2016 can typically be grouped into exits through mergers, buybacks or share repurchases by Indian counterparties, secondary sales, exits through IPOs and public market sales. An easier exit market is a positive development, as PE investments in India have faced liquidity issues in previous years. The financial sector witnessed the maximum level and value of exit-related activity, accounting for US$1.7 billion worth of divestments from approximately 56 deals.

ii Operation of the market

Management equity incentive arrangements

Management equity incentive arrangements in India are most commonly structured through employee stock option plans (ESOP), where the Indian company typically sets up an employee trust to administer the ESOP scheme. Managers and employees are given the option to purchase shares, and the option can be exercised after vesting in the employees. Usually, such options are exercisable in tranches over a staggered period (which may be over a period covering the anticipated duration of the PE investment). The ability of an employee to exercise options in these tranches may also be linked to the satisfaction of performance-based criteria.

The law also allows for other mechanisms such as employee stock purchase schemes, where employees can directly purchase shares at a discount; and sweat equity shares, which are issued at a discount or for consideration other than cash to management or employees for their knowhow, intellectual property or other value additions to the company. There are also a number of other methods through which management incentives can be structured – for example, through issuing different classes of shares or other capital appreciation rights – although these are at a relatively nascent stage in the Indian context.

Standard sales process

As per the above, there is no uniform ‘process’ for PE investments in India. That said, we have witnessed a noticeable increase in bid situations, which in some ways is similar to the Western model of auction sales. However, at its core, PE investments continue to remain relationship-driven, and about evaluating the correct target companies and promoters, establishing a relationship with the promoters and management, and then evaluating any investment proposal on the merits.

Deal cycles and sales processes can vary significantly depending on the sector, the deal size, the parties and regulatory complexity, but there are a few common factors. Finding an appropriate regulatory and tax structure for the deal or sale is among the first discussion points. Thereafter (or often in parallel), one would expect a detailed financial, legal and
technical due diligence, with investors increasingly employing other methods of analysis as well (such as environmental, social and governance diligence or background checks on Indian partners and counterparties). After the investment proposal receives in-principle approvals from the PE investor or credit committee, the definitive documentation for the deal (such as share purchase agreements or shareholders’ agreements) are negotiated and finalised. A typical deal cycle can last between three and six months from the first non-binding indication of interest to the execution of definitive documentation. In certain specific sectors it is possible for the deal cycle to extend up to one year.

After definitive documents are executed, deals may require regulatory approvals (typically these approvals may be from the Reserve Bank of India, the Central Bank, the Securities and Exchange Board of India, the capital markets regulator, the Foreign Investment Promotion Board or the Competition Commission of India. In other sectors (such as insurance or commodities exchanges), there may be other sectoral regulators that may need to approve the transaction). After these regulatory approvals are obtained and other conditions precedent are satisfied, closing can take place. 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.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Legal framework and structuring considerations

Although the legal framework is permissive, there are several regulations around the entry route, types of securities purchased and pricing guidelines applicable to international PE investors. Consequently, many PE investments require appropriate structuring to achieve the desired economics and alignment of incentives.

Foreign PE investors can invest in India under the following entry routes:

- the foreign direct investment (FDI) route, through which investors can acquire equity shares issued by Indian companies or other permitted instruments fully and mandatorily convertible into equity shares in accordance with pricing guidelines described in the table below;
- the portfolio investment scheme (PIS), pursuant to which registered foreign portfolio investors (FPIs) (erstwhile FIIs) can invest in listed securities and other instruments specifically permitted by the PIS regime – in particular, the PIS route is used by foreign investors holding listed equity positions or corporate bonds (such as listed non-convertible debentures (NCDs)) in Indian companies; or
- the foreign venture capital investment (FVCI) scheme.

A high-level overview of each of these schemes is summarised in the table below.
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<th>Entry route</th>
<th>FDI</th>
<th>PIS</th>
<th>FVCI</th>
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<tr>
<td><strong>Overview</strong></td>
<td>For investment in Indian companies by way of equity shares and mandatorily convertible equity securities (both listed and unlisted)</td>
<td>For acquiring listed debt and equity securities (including NCDs) listed on recognised Indian stock exchanges and other securities specified under the PIS scheme</td>
<td>For venture capital investment in sectors identified by the Reserve Bank of India (RBI) (permissible sectors) *</td>
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<td><strong>Types of securities and eligible instruments</strong></td>
<td>Listed and unlisted equity securities as set out below:</td>
<td>Listed and unlisted debt instruments, equity instruments listed on a recognised stock exchange and other specified instruments’</td>
<td>a) Equity or equity-linked instruments of companies in the permissible sectors; b) debt or debt-linked instruments of companies in the permissible sectors; and c) units of venture capital funds or alternate investment funds</td>
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<td></td>
<td>a) equity shares;</td>
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<td>b) fully, compulsorily and mandatorily convertible debentures;</td>
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<td>c) fully, compulsorily and mandatorily convertible preference shares;</td>
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<td>d) partly paid-up shares; and</td>
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<td>e) warrants</td>
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<td>For partly paid-up shares and warrants, there are detailed conditions applicable to upfront amounts, time periods for investing the remainder of funds, and conversion and strike prices</td>
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<tr>
<td><strong>Key investment caps</strong></td>
<td>a) In most sectors, investment up to 100 per cent of the paid-up equity capital of a company is permitted under the automatic route (i.e., without government approval); and b) In certain sensitive sectors (inter alia, aviation, banking, defence, insurance), investment is subject to prescribed sectoral caps or may require prior government approval, or both</td>
<td>A single FPI can hold up to 10 per cent of the paid-up equity capital of a company or 10 per cent of the paid-up value of each series of convertible debentures (this will be calculated on an aggregate basis for a single investor group if the investments are beneficially held by the same entity)</td>
<td>Up to 100 per cent of the paid-up equity capital of a company that is involved in a permissible sector</td>
</tr>
<tr>
<td><strong>Registration requirements</strong></td>
<td>No registration required under FDI scheme</td>
<td>FPI registration with a designated depository participant authorised by the Securities and Exchange Board of India (SEBI) (subject to the satisfaction of specified eligibility criteria)</td>
<td>FVCI registration with SEBI (subject to the satisfaction of specified eligibility criteria)</td>
</tr>
<tr>
<td><strong>Pricing and valuation</strong></td>
<td>Pricing guidelines under the FDI scheme are applicable as follows: For listed companies: a) transfer of shares from a resident to a non-resident by private arrangement must take place at a price greater than or equal to the higher of the average weekly high and low closing share prices over the preceding 26 weeks, and two weeks from the relevant date (Listco FMV); b) transfer of shares from a non-resident to a resident by private arrangement must take place at a price less than or equal to the Listco FMV; and c) preferential allotment of shares must take place at a price not less than the Listco FMV</td>
<td>FPIs are allowed to sell and purchase securities at the stock exchanges at the prevailing market prices</td>
<td>No pricing guidelines are prescribed under the FVCI scheme – parties can mutually agree pricing without regard to exchange control regulations</td>
</tr>
</tbody>
</table>
**ii  Fiduciary duties and liabilities**

Under the Companies Act, 2013, directors of companies (including nominee directors appointed by PE investors) have the following duties:

| a | to act in accordance with the articles of the company; |
| b | to act in good faith, and to promote the objects of the company for the benefit of its members as a whole and in the interests of the company, employees, shareholders, community and the environment; |
| c | to act with due and reasonable skill, care and diligence; |
| d | to exercise independent judgement; |
| e | not to be involved in a situation that may lead to a direct or indirect conflict or possible conflict of interest with the company; |
| f | not to achieve or attempt to achieve any undue gain or advantage either to themselves or to their relatives, partners or associates. A director who is found guilty of making such undue gain shall be liable to compensate the company; and |
| g | not to assign their office to any other person (such assignment, if made, shall be void). |

The most important change to directors’ duties from the pre-2013 regime is that directors must act in the ‘best interests of the employees, shareholders, the community and for protection of the environment’. Previously, all duties of directors were owed to the company and not to other stakeholders. Directors must now take into account a much broader range of factors and stakeholders in their decision-making process.

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 a person or one of the directors to be responsible for ensuring compliance with all operational compliance requirements. Additionally, since liability will be attracted in cases where the nominee director receives proceedings of the board or participates in the meeting...
of the board without raising an objection, investors should ensure that its nominee directors record their objections in writing or ensure that their objection is recorded in the minutes of the meeting.

The PE firm, as a shareholder in a target company, does not have any 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). There are no fiduciary duties or liabilities owed to other constituencies in the capacity of a shareholder.

III YEAR IN REVIEW

i Recent deal activity
PE investment in India continued to be strong despite issues arising from a weak currency, high valuations, and global uncertainty caused by the Brexit referendum and volatility in crude oil prices. Overall, the technology and the financial sector attracted PE investments of around US$6 billion, of which approximately US$3.1 billion were investments in the information technology sector.

Despite substantial efforts by the government to boost investments in the start-up sector in 2015 and 2016, high valuations demanded by entities such as Flipkart and Zomato led many investors to shy away from long-term capital commitment in untested businesses and show increased interest in mature and profitable businesses. We expect this trend of cautiousness towards the start-up sector to continue in 2017.

ii Financing
In India, options for leveraged buyouts and acquisition financing have historically been limited because Indian banks are not allowed to lend for the purposes of the acquisition of shares. Non-banking financial companies (NBFCs) are financial institutions operating in the financial services sector and also provide financing. NBFCs are also regulated by the RBI. NBFCs are subject to much less stringent prudential regulation than banks, but have higher capital requirements (15 per cent capital to risk-weighted assets ratio). Therefore, the ability of NBFCs to provide financing for the acquisition of shares is limited. In 2014, the RBI imposed more restrictions on NBFCs lending against shares by requiring a loan-to-value ratio of 2:1 for all funds advanced for share financing with shares as collateral, which restriction continues to exist in 2016. Further, Indian entities are not allowed to raise external commercial borrowings (loans from offshore lenders) for the purposes of the acquisition of shares. India’s FDI policy also prohibits foreign-owned or controlled companies incorporated in India from leveraging funds from the domestic market for acquiring the shares of another Indian company. Since traditional financing may result in regulatory scrutiny, PE investors are now increasingly using innovative methods to structure around these restrictions. These include fundraising and security creation overseas, and use of less stringently regulated debt instruments such as non-convertible debentures (which are outside the external commercial borrowing regime) to finance the deal.

Unlike in Western markets, PE investors do not really have access to Indian banks or financial institutions to finance a transaction. For Indian transactions, international PE investors will normally deploy their own funds raised from their investors or through funds leveraged offshore and subsequently brought into India as equity. However, the past two years
have seen a number of acquisitions finance and leverage buyout deals, with innovative and bankable transaction structures. Accordingly, using leverage financing in Indian PE deals has become much more credible over the past two years.

iii Key terms of recent control transactions

Unlike the Western model, where public-to-private transactions or leveraged buyout transactions will involve management buyouts or taking control of the target company, the significant majority of PE investments in India had previously involved the acquisition of minority stakes. However, like in 2015, in 2016 there were several notable control transactions completed by PE investors, showcasing a shift towards acquiring a majority stake in the target companies that stems from investors’ preference of having a greater say in the way these acquired businesses are managed (and grown), as well as more control over exit opportunities and processes, hoping for faster exits and better returns.

In control transactions where PE investors acquire 100 per cent or a majority stake of the target company, there are two models: the PE investor will either hire a fresh management team with a buyout of the whole or majority stake in the company from the existing shareholders, or the PE investor will acquire the whole or majority stake with the pre-existing management team staying on. In the latter case, the Indian shareholders or promoters may actually be responsible for running the day-to-day operations of the company and formulating the long-term business strategy, and may often have the right to repurchase the PE investor’s stake or to provide an exit to the PE investor.

A trend becoming increasingly popular among PE investors in India is engaging operating professionals who are proven leaders in the relevant sector with the ability to accelerate value creation. Considering the increased focus on control acquisitions, we expect engagement of operating partners to continue to be a trend over the next few years.

One of the largest control acquisition transactions in 2016 was Brookfield Asset Management agreeing to acquire 51 per cent per cent of Towercom Infrastructure Pvt Ltd for approximately US$1.6 billion. Other notable control acquisition transactions in 2016 were Blackstone acquiring a 60 per cent stake in Hewlett Packard’s IT services and business process outsourcing (BPO) firm Mphasis for US$825 million, and AION acquiring a 100 per cent stake in GE Capital Services India (an NBFC) for US$330 million.

iv Exits

In 2016, PE investors exited investments worth approximately US$6.7 billion to US$10.3 billion, with some of the significant transactions being the following:

a KKR’s exit from Alliance Tire Group by the sale of its 90 per cent stake to Japan’s Yokohama for approximately US$942 million to US$1.2 billion, making it one of India’s largest PE exits to date. The deal generated returns in excess of 2x;

b Temasek’s exit from Bharti Telecom Ltd (the parent company of Bharti Airtel) through the sale of its 7.39 per cent stake to SingTel (the Singapore-based telecommunication major) for approximately US$657 million;

c KKR’s exit from Gland Pharma Ltd through a sale of its 36 per cent stake to Shanghai Fosun Pharmaceutical (Group) Co Ltd for US$577, generating estimated returns of 2.8x;

d Blackstone Group’s exit from International Tractor Limited by selling its 17.75 per cent stake to Japan’s Yanmar Co for US$250 million, generating approximately a 3x return on its 2012 investment; and
Capital Square Partners Pte Ltd and CX Management Ltd’s exit from their US$260 million investment in Minacs Pvt Ltd (a BPO firm) by the sale of shares to Synnex Corp for US$420 million. The exit generated a plus 1.5x return on their 2014 investment.

It is no surprise that 2016 saw a substantial number of PE exits through IPOs, through which companies raised approximately US$3.8 billion. These figures are almost double compared to funds raised by companies through IPOs in 2015. A few notable PE exits in 2016 are provided below:

- In the IPO conducted by Equitas Holdings Ltd, several PE funds, including Sequoia Capital, Aavishkaar Goodwell India Microfinance Development Co Ltd, Aquarius Investments Ltd and WestBridge Ventures, exited through a sale of approximately 38 per cent of the company’s pre-IPO stake for approximately US$224 million;
- In the IPO conducted by RBL Bank, several PE funds such as Elephant Capital Fund, Beacon India Private Equity Fund, Gaja Capital Fund, Capvent India Private Equity Fund opted for an exit of approximately US$58 million;
- Actis Advisers Private Limited opted for a complete exit of 13.72 per cent from Endurance Technologies Ltd at a multiple of approximately 1.9x;
- CX Partners opted for a partial exit of 19 per cent of the share capital for approximately US$56 million from Tyrocare Technologies Limited; and
- In the IPO conducted by Dilip Buildcon Ltd, BanyanTree Growth Capital exited through a sale of 10 per cent of the company’s pre-IPO shares for approximately US$36 million at a multiple of 3x.

IV REGULATORY DEVELOPMENTS

i Relevant regulatory bodies

In the context of PE investments, the relevant regulatory bodies in India are as follows:

- The RBI, which is the central bank and monetary policy authority of India, and also the foreign exchange regulator. The RBI is the executive authority under the Foreign Exchange Management Act, 1999, the key exchange control law in India, and is responsible for notifying regulations on various aspects of foreign exchange and investment transactions from time to time;
- SEBI, India’s capital markets regulator, which regulates all stock market activity. Therefore, SEBI regulations are applicable when PE firms invest in publicly listed securities; and
- The Competition Commission of India, the competition regulator, which is required to pre-approve all PE transactions that fall above the thresholds prescribed in the Competition Act, 2002.

The Companies Act, 2013, the Companies Act, 1956 (to the extent applicable) and the rules made thereunder by the Ministry of Corporate Affairs form the basic corporate regulatory framework in India.

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 RBI oversees
banks and financial services companies, the Insurance Regulatory Development Authority oversees the insurance sector and the Directorate General of Civil Aviation oversees the aviation sector.

ii Key regulatory developments
As previously mentioned, over the past year the government has relaxed several conditions under the FDI regime.

The government has either liberalised or abolished foreign investment restrictions in the following sectors.

Pension sector
Sectoral limits for foreign investments in the pension sector had been set at 49 per cent (with government approvals required for FDI after 26 per cent). The government now permits foreign investments up to 49 per cent with no requirement for prior governmental approval.

Asset reconstruction companies
Sectoral limits for foreign investments in asset reconstruction companies were set at 100 per cent (with governmental approval required for FDI after 49 per cent). The government now permits investments up to 100 per cent with no requirement for prior governmental approval. Further, the government has abolished restrictions prohibiting a single entity from holding more than 50 per cent of the equity of an asset reconstruction company. In addition, the government has permitted FPIs to hold 100 per cent of each tranche of security receipts issued by an asset reconstruction company (previously, FPIs could hold 74 per cent of each tranche of security receipts issued by an asset reconstruction company).

Defence
Sectoral limits for foreign investments in defence was set at 49 per cent. For investments beyond 49 per cent, the prior consent of the government was required, which was to be granted only in cases where such investments facilitated access to state-of-the-art technology. The sectoral limits for foreign investments in defence have been revised to up to 100 per cent (with no governmental approval required for FDI up to 49 per cent).

Broadcasting
Sectoral limits for FDI in sectors involving teleports, direct to home, cable networks (MSOs), mobile TV, headend in the sky broadcasting services and cable networks stood at 100 per cent (with government approval being required for FDI beyond 49 per cent). The government now permits investments up to 100 per cent with no requirements for prior governmental approval.

Aviation
Sectoral limits for FDI in existing airport projects were set at 100 per cent (with governmental approval required for FDI after 74 per cent). The government now permits investments up to 100 per cent with no requirements for prior governmental approval. FDI in scheduled air transport services and domestic scheduled passenger airlines has been increased to 100 per cent (with government approval being required for FDI beyond 49 per cent).
Private security agencies
FDI in private security agencies has been increased from 49 to 74 per cent (with no governmental approval required for FDI up to 49 per cent).

Single brand retail trading
Clarifications and changes have been made aimed at easing sourcing requirements for retailers, subject to certain conditions being met.

Pharmaceuticals
Previously, FDI in brownfield pharmaceuticals required governmental approval. The government now permits FDI up to 74 per cent without requiring governmental approval in brownfield pharmaceuticals. FDI beyond 74 per cent will require governmental approval.

Non-banking financial companies
Previously FDI was only permitted in non-banking financial companies engaged in certain activities. The government has abolished this restriction. Furthermore, the government has also removed minimum capitalisation requirements for investments in non-banking financial companies.

iii Further regulatory developments
One of the biggest developments in 2016 was the introduction of key regulatory reforms to help fast track commercial disputes in India. In June 2016, the Ministry of Corporate Affairs notified the constitution of the National Company Law Tribunal (NCLT) and the National Company Law Appellate Tribunal (NCLAT). The NCLT and NCLAT replace the Company Law Board, and have been set up as specialised fora to adjudicate all disputes pertaining to companies in India. They have special powers to adjudicate on matters relating to oppression and mismanagement, winding-up of companies, and insolvency resolution processes and matters pending before the Company Law Board, Board for Industrial and Financial Reconstruction and Appellate Authority for Industrial and Financial Reconstruction. In addition to the above, the NCLT has jurisdiction over matters under the newly introduced Insolvency and Bankruptcy Code, 2016 (Code). The Code focuses on creditor-driven insolvency resolution. It aims to provide a time-bound, linear process for resolving insolvency in companies, partnerships and individuals. One of the fundamental features of the Code is that it allows creditors to assess the viability of debtors and agree upon a revival plan. The Code envisages a two-stage process: the insolvency resolution process, where the financial creditors assess the viability of the debtor’s business, and compulsory liquidation if the resolution process fails or the financial creditors decide to wind down the entity. The insolvency resolution process needs to be completed within a period of 270 days. These changes in 2016, along with the introduction of the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 (which allows state governments and chief justices of the high courts to establish commercial courts at the district level, and commercial divisions of the high court), are likely to go a long way in assisting in the speedy disposal of commercial disputes (including those involving PE investors).

The RBI has amended regulations restricting payment of deferred consideration in share acquisitions between residents and non-residents. Prior to the amendment, the consideration for a transaction for the purchase of shares between a resident and a non-resident party was
required to be paid up front. Any deferment in the payment of the purchase consideration required a prior approval from the RBI. After the amendment to the regulations, up to 25 per cent of the consideration for a share purchase may be deferred up to 18 months. Since a holdback of purchase consideration, post-closing price adjustments and post-closing working capital adjustments are commonly negotiated issues in PE deals, this is a positive development towards improving the ease of doing business and entering into transactions with more globally consistent terms in India for PE investors.

In 2016, Parliament also introduced a goods and services tax regime in India. The goods and services tax is proposed to replace indirect taxes and levies charged by the central and state governments. In its latest budget speech, the government has indicated that the revised goods and services tax regime will come into effect from 1 July 2017.

V OUTLOOK

Although growth projections were scaled down because of the government’s demonetisation policy (the International Monetary Fund (IMF) cut its growth forecast for the Indian economy from 7.6 to 7.2 per cent for financial year 2017), the overall outlook remains positive, with the OECD and IMF predicting strong GDP growth during 2017. However, in our view, significant challenges need to be overcome before all of the expected benefits can be reaped. In this section, we set out a few of the key themes that we expect will be significant factors in 2017.

i Capital requirement

Many corporates in India continue to be cash-starved with highly leveraged balance sheets. With the recent overhaul of the large caches of non-performing assets at Indian banks, banks are exercising caution when lending to corporates. This has resulted in an urgent need for equity capital and good opportunities for PE investors. Although both local and foreign PE investors have sufficient ability to fund, we expect them to exercise some caution while pumping capital into India in 2017. To encourage PE investors, it is likely that the government will introduce further relaxation of the rules governing foreign investment and lending into India.

ii Bridging the valuation divide

In 2014 and for large part of 2015, a common complaint among fund managers was the expectation mismatch (with Indian promoters) on valuations of Indian assets. 2016 saw a valuation correction in the start-up sector. However, from an overall perspective, valuations continued to ride high. With demonetisation and the recent changes in the global market, we expect a significant level of valuation correction in 2017 across sectors. This will, hopefully, narrow the difference between the bid and the ask, leading to higher PE investments in 2017.

iii Spotlight sectors

The IT, industrial and financial sectors saw significant investor interest in 2016. The year also saw various PE funds express interest in entering into the distressed assets market in India. With banks under pressure to clean their books, and the volume of non-performing assets in the banking system estimated as exceeding US$4 trillion, we expect there to be a significant uptake in the distressed assets market in 2017.
The realty sector has witnessed a high level of growth over the past few years. It is expected that the sector will continue to grow in the next year on account of recent liberalisation in the sector, including the much-awaited debut of real estate investment trusts (REITs) in the Indian market. In October 2016, Blackstone and the Embassy Group made India’s first application to the SEBI for setting up a REIT. Other private funds likely to set up REITs in the near future include Canada Pension Plan Investment Board and Brookfield.

iv Different asset classes
PE firms are increasingly looking at hybrid deal structures to either provide high-cost (and mezzanine) debt financing for last-mile funding in projects that are nearing completion (with existing equity investors agreeing to high-cost debt in the interest of project completion), or through combination deals with debt and equity to protect the downside risks. As a result, the market for corporate bonds (and innovative structures involving debt instruments) has been booming, and we expect this trend to continue in 2017. This is a win-win situation for both PE investors and target companies, as debt financing allows for easier repatriation of funds for PE investors and relatively quick cash for companies in need of funding.

v Easing regulatory restrictions
As discussed elsewhere in this chapter, we expect the government to continue liberalising foreign investment regulations and take steps to improve the ease of doing business in 2017. For instance, in its budget for financial year 2017, the government has recommended abolishing the Foreign Investment Promotion Board (FIPB), a regulatory body set up to regulate foreign investments in India. Abolishing the FIPB is expected to streamline foreign investments in India and to improve India’s ‘ease of doing business’ rankings.

vi Sophisticated deal making
We witnessed increasing levels of sophistication in 2015 and 2016 in structuring PE investments, and we expect this trend to continue in 2017. We also saw PE investors learn from the experiences of the past few years, and an increased focus on viable exit options for all new investments.

In 2017, we can continue to expect PE firms to focus on background checks and business diligence of potential counterparties, effective post-investment monitoring (through information rights and annual third-party conducted audits), higher corporate governance standards, greater attention to standards of documentation and a realistic risk assessment in light of recent experiences. From a deal structuring standpoint, PE firms will apply significantly more thought to entry and exit structures (i.e., using the most appropriate capital instrument or combination of instruments with terms attaching to them (such as sliding scale conversion rights or control)) to align investor incentives with the Indian counterparty’s incentives.

vii Exits, anyone?
Given the amount of existing PE investments that are nearing the end (or have reached the end) of their investment cycles, we expect to see a significant amount of restructuring activity in 2017 (as simultaneous exits will crowd the market, making it an unviable proposition). Further, with capital markets continuing to remain bullish, we also expect more companies will be able to provide exits to their investors through the IPO route.
While our long-term view on India is that ‘the best is yet to come’, in the medium term (specifically throughout 2017) we believe that the state of the global markets and the results of the government’s liberalisation efforts will determine whether India will be on the radar of PE investors.
I OVERVIEW

i Deal activity

Overall mergers and acquisitions in 2016 decreased by 14 per cent in volume (from 236 to 202 deals) from 2015 and in value by 72 per cent (from approximately €29 billion to €7.9 billion). Deal volume fell below the 10-year average of 211 deals per annum as the uncertainty caused by the decision of the UK to leave the EU and the outcome of the US general election led to a number of transactions being put on hold or reconsidered. Q3, a traditionally strong quarter for deal activity, recorded the lowest number of deals since the first quarter of 2010. The significant decrease in deal value when compared with 2015 can be largely explained by three exceptionally large transactions which occurred in 2015, namely CRH’s €6.5 billion acquisition of certain assets of Holcim Ltd and Lafarge SA, Bohai Leasing’s €6.5 billion acquisition of Avolon Holdings Limited, and Paddy Power and Betfair Group’s €3.8 billion merger.

Sixty-seven merger notifications were made to the Irish Competition and Consumer Protection Commission (CCPC) in 2016, representing a decrease of approximately 14 per cent from 78 in 2015. The reduction was most pronounced in the fourth quarter with a drop from 26 to 19 (i.e., 27 per cent) which is further evidence of the impact that the uncertainty generated by Brexit has had on the market. The greatest number of notifications were made in the commercial property, hotel, food and beverage, healthcare, and pharma sectors. Private equity firms were party to 20 merger notifications made in 2016, representing 30 per cent of the total number of notifications made, compared with an average annual total of 28.9 per cent during the period from 2010 to 2015.

The volume of private equity deals in 2016 remained largely on par with 2015 (49 deals were recorded in 2015 and 50 in 2016). However, deal value (in respect of disclosed consideration for private equity transactions) decreased by approximately 27 per cent from €10.5 billion in 2015 to €7.6 billion in 2016. While the value of PE transactions reflected a marked decrease, the stable volume of transactions demonstrates the overall increased level in economic activity in Ireland over the last five years. To place this in context, the disclosed value of private equity buyouts increased from €448 million in 2012 to approximately €1.7 billion in 2016, while the disclosed value of private equity exits increased from €40 million in 2012 to approximately €3.7 billion in 2016.

1 David Widger is a partner at A&L Goodbody.
There were 12 private equity exits during 2016. This is broadly on par with last year’s figures, with 13 exits in 2015, but remains a marked 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 due to reduced asset valuations and the lack of domestic operators with access to acquisition finance. Foreign private equity sponsors in 2016 included entities from the United States, Canada, Norway, the United Kingdom, Germany and Japan.

**ii Operation of the market**

As is the case in the UK, 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 such management to take an equity stake in the investee company.

Usual equity incentive arrangements used in Ireland consist of the following:

- **a** Shares: normally, non-preference shares in the investee company are subscribed for, for a nominal amount, by the managers who are to be incentivised; those shares then achieve capital appreciation on a successful exit by the private equity investor.

- **b** Ratchet mechanisms: under a ratchet mechanism, continuing key shareholders and management may be given increased or decreased share rights (as the case may be) in the investee company (ratcheted up or ratcheted down) according to an agreed performance formula or with reference to exit valuations achieved by the private equity investor.

- **c** Share options: the relevant investee company (under terms prescribed by the private equity investor) grants options to subscribe for shares in the capital of the investee company. Such options would normally have a vesting period before they can be exercised, thereby ensuring that the option holders are incentivised to drive the investee company’s performance for the required private equity investment period. The options would also normally be subject to good-leaver or bad-leaver provisions.

In addition to equity incentives, it is common for private equity investors to agree non-equity (such as cash) bonus arrangements with key management or employees – again linked to the investee company’s target performance. It is important to structure such bonus payments to Irish residents in a manner that minimises the amount of income tax payable.

In a similar manner to the UK, the Irish 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 right up until relatively recently, 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 pick up in the domestic M&A market in 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** a 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 (being 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 avail of the benefit of limited liability, as the liability of each member, including the private equity sponsor, is (absent 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 more than Irish companies as fund structures 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 of 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:

\[ a \] leverage of warranties, indemnities or non-compete covenants;
\[ b \] board representation and quorum rights;
\[ c \] information and reporting rights;
\[ d \] veto rights;
\[ e \] step-in rights;
\[ f \] preferred equity share rights;
\[ g \] pre-emption rights; and
\[ h \] 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 such structuring.

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.

ii  Fiduciary duties and liabilities
The private equity sponsor must first understand what, if any, fiduciary duties it owes private equity investors investing through the private equity fund it has established in Ireland, and second understand the fiduciary duties that the fund itself owes other shareholders in the portfolio investee companies the private equity investor invests in.

No fiduciary duties as such exist between shareholders under Irish law – unlike directors, who are obliged not to act in breach of their fiduciary duties to the company of which they are a director. Further, as a general principle, shareholders may also vote as they please; the right to vote being a personal right of the shareholders, they are generally free to act in their own interests and to exercise their own judgement as to how they vote.

Private equity sponsors’ representatives on a portfolio investee company’s board (nominee directors) owe the same duties to the relevant investee company as any other director. Nominee directors should bear in mind that they, like all directors, are subject to the obligations contained in the Irish Companies Act, and elsewhere in respect of listed and regulated entities, with regard to directors and disclosure of conflicts of interest.

Nominee directors also owe fiduciary duties to creditors, where a company is insolvent or in a ‘zone of insolvency’; and employees and shareholders, to the extent the Irish courts now view the interests of a company’s employees and shareholders as interests of the company itself.

The Irish Companies Act, which commenced on 1 June 2015, consolidated and introduced certain reforms to pre-existing Irish company legislation, including the codification of directors’ fiduciary duties and directors’ liability to account to the company for gains made and to indemnify the company for losses caused as a result of their breach of duty.

There are numerous situations where a company director can face personal liability other than for breach of his or her fiduciary duties as a director, and can also face heavy fines and sometimes imprisonment for breaches of the requirements of various statutes such as those relating to company, environmental, and health and safety law. Shadow directors are also included in the definition of ‘director’ for many offences.

In the context of insolvency, directors may also face liability where they make an inaccurate declaration required to allow a private company to give financial assistance for the purchase of its own shares (an act ordinarily prohibited under the Irish Companies Act), engage in ‘fraudulent’ or ‘reckless’ trading, misapply company assets, make an incorrect declaration of solvency in the context of a voluntary liquidation or buy shares in a company’s holding company in certain circumstances.
On insolvency of a company, a director may also face ‘restriction’ or ‘disqualification’ for up to five years or such other period as the courts think fit.

Under the Limited Partnership Act 1907, the GP of a limited partnership is akin to a member of an ordinary partnership, and is liable for all debts and obligations of the partnership. The GP (or manager) controls the business of the partnership and so is involved in its day-to-day management. To this effect, the GP is authorised to bind the partnership in relation to partnership business, and to negotiate and execute documents, and he or she is also liable, without limitation, for the debts of the partnership.

Irish law continues to support the fundamental principle that a company possesses a separate legal identity from its shareholders. A private equity investor shareholder, no matter how great the extent of its shareholding or of the control exercised by it over the board of directors in an investee company, cannot normally be made liable for the debts of that investee company.

In very exceptional circumstances, usually involving some level of wrongdoeing 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 carveouts where Irish courts are willing to pierce the corporate veil, there is also statutory provision under Irish law for the imposition of ‘related company’ liability on two separate Irish companies. Section 599 of the Irish Companies Act allows a court to make an order requiring one company to contribute to the debts and liabilities of another insolvent ‘related’ company in circumstances where the court considers it just and equitable to make such an order.

In reality, it is difficult to foresee in the event of a claim against any investee company how the relevant private equity investor would be held responsible for the resulting liabilities of the investee company.

In terms of raising finance to invest in investee companies, the use of a limited partnership structure, as opposed to a limited liability corporate structure, typically has no material adverse consequences or implications for lenders to that structure, nor does it affect

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2 A company is deemed to be ‘related’ to another company:
   a. where it is its holding company or subsidiary;
   b. where it or its other group companies own more than 50 per cent of the share capital;
   c. where its own members own more than 50 per cent of the share capital;
   d. 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;
   e. where there is another company to which both companies are related; or
   f. where the businesses of the companies have been carried on in such a way that the separate business of each company is not readily identifiable. (This last proviso does not however affect the general principle that group companies are recognised to be separate legal entities even where they are interrelated and interact on a day-to-day basis. For Section 140 to be invoked, something beyond normal group trading is required.)
the 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, which 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 of time 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, there was a reduction in the value of private equity deals in Ireland in 2016 as the uncertain economic conditions subdued the level of big ticket transactions. Based on figures available from Mergermarket (in respect of disclosed consideration for private equity transactions), the aggregate private equity deal value (comprising both buyouts and exits) in Ireland in 2016 fell back to 2014 levels (approximately €7.6 billion), although the 50 reported deals in 2016 remained on par with the volume recorded in 2015. It should be remembered that 2015 was an exceptional year as regards the value of deals recorded
(49 transactions with a value of approximately €21 billion), particularly when compared with previous years; for example, 31 transactions were recorded worth €7.59 billion in 2014 and 18 transactions worth €448 million in 2012.

As regards the wider M&A market in Ireland, a total of 60 deals were recorded during the first quarter of 2016 at a value of €1.5 billion, representing a decrease of 12 per cent on the volume recorded during the same period in 2015. Noteworthy deals recorded during the quarter included the acquisition of Creganna-Tactx Medical by TE Connectivity for €824 million, the acquisition of INPA SA and Paema Embalagens by Smurfit Kappa Group for €186 million and Worldview International Management acquiring a 70.4 per cent stake in Petroceltic International for €167 million.

In quarter two of 2016, a total of 53 deals were recorded with an aggregate deal value of €1.3 billion. Significant transactions included GIC Private Ltd’s acquisition of a 16 per cent stake in Eir for a reported value of €230 million, the acquisition of Highline Produce Ltd by Fyffes plc for €97.7 million and Carlyle Cardinal Ireland’s acquisition of AA Ireland for €157 million.

Following the unexpected Brexit vote in June, deal value (approximately €2.8 billion) and volume (39 deals) in quarter three were lower than in the same period in 2015. The acquisition by Verizon Communications of Fleetmatics Group for a reported value of €1.96 billion was the stand-out deal reported.

Fifty deals were recorded in the final three months of 2015 with an aggregate deal value of €2.3 billion. Prominent transactions recorded during the quarter included Sumitomo Corporation’s acquisition of Fyffes plc for a reported value of €850 million, Greencore Group’s acquisition of Peacock Foods for €694 million, Acasta Enterprises’ acquisition of Stellwagen Finance Company for €247 million and DCC’s acquisition of Gaz Europeen SAS for a reported value of €110 million.

**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 have seen an increase in the number of Irish companies tapping into the equity capital markets both in Ireland and overseas such as Cairn Homes, Malin Corporation, Hibernia REIT, Dalata, Prothena Corporation and Presbia. However, in line with the global trend, both deal numbers and proceeds raised in 2016 finished markedly lower than in 2015.

In the leisure sector, Cairn Homes, which floated on the London Stock Exchange in March 2015 and raised approximately €400 million from investors, completed a €176 million secondary equity capital raise by way of placing and open offer in 2016. Cairn’s IPO was the first Irish house builder to float on the stock exchange since 1997.

Other noteworthy transactions during 2016 include Providence Resources’ €65 million secondary capital raise by way of placing and open offer, and Oneview Healthcare’s €40 million IPO and admission to the Official List of the Australian Securities Exchange.

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, which 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 such funding has only recently begun to recover towards previous levels again.

Most private equity funds established in Ireland continue to have a term of 10 years, with the possibility of extending that term to allow a greater period for liquidating the fund’s interests in all portfolio investee companies. Typically, funds have an initial investment period of three to five years to source and invest in new companies. Following this initial investment period, the terms of the fund generally restrict its purpose to managing and making follow-on investments in existing portfolio investee companies.

Generally, private equity funds look for returns of between 30 and 40 per cent per annum by way of capital gain.

As noted above, most private equity funds operating in Ireland invest in investee companies by subscribing for preferred equity in the capital of the investee company. Occasionally they take a mix of equity and debt, in the form of loan notes of the investee company (which may also be convertible into equity). The preferred equity rights generally include a combination of liquidation preference rights, veto rights over prescribed actions by the investee company and its management, and anti-dilution protections.

Preference shares are also generally convertible into ordinary shares at the discretion of the private equity investor, and automatically convert on the occurrence of certain agreed exit events, for example, an IPO at a pre-agreed minimum valuation of the investee company.

In certain circumstances (e.g., where the investee company requires short-term bridging finance), private equity funds may also lend money, either by way of a straight loan or convertible security, to investee companies.

iii Key terms of recent control transactions

FleetMatics Group Plc
Verizon Communications Inc, a US-based listed provider of communications and entertainment services acquired FleetMatics Group plc, the US listed and Irish incorporated provider of fleet management solutions, for €1.9 billion.

Fyffes plc
Sumitomo Corporation, the Japanese listed conglomerate, and Fyffes plc, the Irish listed distributor of tropical produce, reached agreement on the terms of a recommended cash offer worth over €750 million to be effected by way of a scheme of arrangement.

Peacock Foods
Greencore Group plc, the Irish listed international convenience foods manufacturer acquired Peacock Foods, a US-based convenience food manufacturer for €694 million.
**AA Ireland**

Private equity fund Carlyle Cardinal Ireland made its seventh Irish investment with the acquisition of AA Ireland, the motoring services provider and insurance intermediary, for €156 million.

**iv Exits**

As already stated, the number of private equity exits in Ireland in 2016 was broadly on par with 2015. The average value of private equity exits in 2016 (based on publicly disclosed deal value) was approximately €3.7 billion, which marked an increase on 2015 due principally to the Verizon/Fleetmatics transaction. 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.

**Creganna-Tactx Medical**

TE Connectivity Ltd, a listed Switzerland-based company, acquired Creganna-Tactx Medical, a provider of outsource design and manufacturing services to the medical device industry, who are headquartered in Galway, for €824 million. Permira Advisers LLP, a UK-based private equity firm, was the seller.

**Xtralis Pty Ltd**

Honeywell International Inc acquired Xtralis Pty Ltd for €438 million. Xtralis Pty Ltd is an Irish-based provider of aspirating smoke detection solutions along with perimeter security technologies and video analytics software. The sellers were Blum Capital Partners LP, a US private equity firm and Pacific Equity Partners, an Australian private equity firm.

**Eir**

GIC, Singapore's sovereign wealth fund, acquired a 16 per cent stake in Eir, Ireland's largest telecoms operator, from a number of minority shareholders for €230 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 business plan) to the Irish Central Bank. Directors 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 of 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 Central Bank of Ireland 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 came into operation on 15 November 2016. Certain Irish corporates 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 the Regulations, are natural person(s) 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.
V OUTLOOK

Private equity activity, which slowed down in 2016 after a number of years of consistent improvement in terms of disclosed deal value and volume, is likely to stabilise in 2017. 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 2017.

There is growing speculation that the Irish government could instigate an AIB share sale during 2017 as it seeks to recoup a percentage of its €20.7 billion investment in the bank during the financial crisis.

The recovery of Ireland’s TMT, agri-food, pharmaceutical, and medical and biotech sectors, present significant potential opportunities for private equity activity 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 that Ireland faced over recent years have eased significantly in the last two years, which should see a stabilisation or increase in deal flows and deal values, provided global macroeconomic conditions are favourable. If market activity improves in 2017, 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 2017.

Although bank funding has increased over the past year and is expected to continue to increase in 2017, international private equity providers are also expected to play an important role in Irish M&A activity in 2017 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, being mainly private equity and hedge funds (a significant proportion of which are US-based), will increase the level of secondary disposals of such debt or assets.

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 2017, transactions will likely 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 2017.
Chapter 13

ITALY

Fabio Labruna

I OVERVIEW

i Deal activity

Private equity and venture capital in Italy in the first six months of 2016 (the most recent statistics available at the time of writing) showed, compared with the same period in 2015, a modest decrease in the number of transactions (-18 per cent) but a strong increase in the value of new transactions. Resources invested in the first six months of 2016 amounted to approximately €4,898 billion compared with €1,787 billion invested in the first six months of 2015. The first six months of 2016 – if compared with the same period in 2015 – have been characterised by a prevalence of investments in ICT industries (27 deals corresponding to an increase with respect to the previous year of 19 per cent). Resources has also been invested in business products and services (23 deals corresponding to an increase with respect to the previous year of 17 per cent) and manufacturing (20 deals corresponding to an increase with respect to the previous year of 14 per cent).

In the first half of 2016, early stage transactions turned out to be the most common type of investment, as far as the number of transactions is concerned (50 deals for a total amount of investments equal to €35 million); however, buyouts continued to be the type of investment in the Italian private equity market where more resources has been invested, i.e., €3.404 billion in 42 different transactions. There has also been a considerable increase in the overall value of replacement investments: the invested amount in the first semester of 2016 is equal to €812 million (10 deals) compared to the first semester of 2015 (€359 million for 21 deals). Expansion investments have significantly increased in value: statistics report that the invested amount for the first half of 2016 is equal to €534 millions (26 deals) compared to the amount invested in the same period in 2015 (€266 million for 43 deals).

As far as exit transactions are concerned, figures available to us show that the disinvested amount is equal to €1.518 billion against €1.914 billion of the same period in the previous year (i.e., -21 per cent), for a number of transactions equal to 57 deals against the 99 deals of the first half 2015. In a line of continuity with the trend established since 2011, the kind of transaction that is manly performed in this respect is the sale to other financial investors (68 per cent by value and 26 per cent by number of transactions).

The outlook for the Italian private equity market in the second half of 2016, notwithstanding the persisting situation of economic crisis, provides for an increase in the

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2 Unless otherwise specified, market information is drawn from the AIFI review: ‘The Italian private equity, venture capital and private debt market in the first semester 2016’.
number of deals,\(^3\) thus confirming the limited positive trend of the first semester of 2016. In this respect, market operators expect that a limited growth will characterise the Italian industry in 2017.

ii Operation of the market

As a consequence of the financial crisis, the legislature in Italy, as in several other European countries, has devoted a lot of attention to regulating management equity incentive schemes. This, combined with a shift of ‘abuse of law’ from a doctrinal theory into real ‘hard law’ (see Section II, infra) has significantly diminished the number of schemes adopted in private equity deals.

Since 2008, pursuant to Article 50 of DPR No. 917 of 22 December 1986, Italy has taxed as the personal employment income of the beneficiaries of stock option plans, the difference between the value of the instruments (shares and others) at the moment of the exercise of the option and the payment of the subscription. Notwithstanding that this tax treatment is generally considered to be unfavourable, the vast majority of private equity transactions are structured using plain ‘vanilla’ stock option schemes because of the uncertainty connected to the proliferation of the concept of ‘abuse of law’. As a result, equity incentive schemes connected to investments in holding companies in Luxembourg (or in other jurisdictions) continue to diminish.

While the continuing instability on the financial markets favours under-the-radar sales, which do not follow well-defined paths, competitive sales continue to be structured in different phases (management presentation, non-binding offers, first-round binding offers, second-round binding offers, due diligence and transaction documents negotiations). The average duration of a competitive sale in Italy is approximately three to four months but of course this may substantially vary depending on a number of circumstances such as regulatory clearances, the complexity of the due diligence process, the competitive environment and other issues.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Private equity investments in Italy are typically implemented through the use of a special purpose vehicle (SPV) incorporated in Italy or in another European jurisdiction (see, however, Section IV, infra, about the introduction by Legislative Decree No. 44 of 4 March 2014, of a new investment vehicle, the so-called ‘Sicaf’). No proportional capital duty arises for the formation of an SPV in Italy, registration tax is negligible and recent reforms to the Italian Civil Code (ICC) have introduced greater flexibility in the construction of the capital structure of stock corporations (SpA) and limited liability companies (Srl), the two main legal forms of company incorporation in Italy.

Therefore, Italian SPVs are in far more common use today in private equity investments. As a general principle, Italian law provides for a corporate veil shielding the shareholders from liabilities assumed by the SPV. This principle suffers from certain limited exceptions, the most recent and relevant of which is the threat posed by the development of the ‘parental liability’ theory in European antitrust matters (as explained more in detail below).

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\(^3\) Deloitte, Italy Private Equity Confidence Survey, 2016.
As far as limited liability companies (Srl) are concerned, the Board of Notaries of Milan, on 17 May 2016 issued a new interpretation of Article 2469, Paragraph 2 ICC, regarding the lock-up clauses inserted in the by-laws of such companies. Article 2469, Paragraph 2 ICC, literally states that if lock-up clauses are inserted in the by-laws, the quotaholders are entitled to exercise the withdrawal right; however, the by-laws of the company may provide that the quotaholders are not entitled to exercise such withdrawal right for a two-year period running from the date of incorporation of the company or the subscription of the quotas (as the case maybe). In a nutshell, according to Article 2469, Paragraph 2 ICC, lock-up clauses in limited liability companies (Srl) may prevent quotaholders from leaving the company only for a maximum two-year period. The Board of Notaries of Milan, instead, has maintained that the withdrawal right can also be excluded for a longer period, provided, however, that the prohibition to transfer the quotas remains temporary, in light of the purpose and the duration of the company. As a consequence, the above withdrawal right might be excluded for a period of time longer than two years, if the company continues its duration for further years.

Apart from the above, critical to the acquisition of control remains the ability to appoint a majority of the members of the board of directors. This goal is typically attained in privately held companies by acquiring the interest or voting rights to the majority of the common share capital of the target company and thus gaining the ability to control shareholders’ meetings, which in turn appoint the directors.

Following the 2003 reform of the ICC the ability to acquire minority interests in Italian companies has been significantly increased. In particular, there is greater flexibility to transpose certain typical minority rights (such as the right to appoint directors, statutory auditors and veto rights) into the by-laws of the target company and the provision to tailor special classes of shares issued to minority investors.

A new material instrument of flexibility is represented by the recent overcoming of the ‘one share, one vote’ rule. Law No. 116 of 11 August 2014 amended Article 2351 ICC and introduced the possibility for unlisted companies to create shares with multiple voting rights (maximum three for each share) or to limit the voting rights owned by a shareholder in relation to the overall amount of his or her shares. The same Law also inserted a specific provision (Article 127 quinquies) in Legislative Decree No. 58 of 24 February 1998 (the Unified Financial Act), which allows the by-laws of listed companies to create 'loyalty shares', attributing increased voting rights (up to two votes) for each share owned by a shareholder for a minimum period of 24 months. Such increased voting rights are lost in the case of transfer of the related shares, as well as in the case of transfer of controlling interests in companies where more than 3 per cent of the corporate capital is represented by shares with increased voting rights (5 per cent if the company is an SME).

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4 Opinion of the Board of Notary of Milan No. 152, issued on 17 May 2016.
5 Pursuant to Article 1, Paragraph 1, w-quater.1) of the Unified Financial Act, as recently emended by Legislative Decree 15 February 2016 No. 25, SMEs are the listed small and medium enterprises ‘whose turnover also prior to the admission of their own shares for trading, is lower than €300 million, or whose market capitalisation is lower than €500 million. Issuers of listed shares that have exceeded both the aforesaid limits for three consecutive years are not considered SMEs.’
Moreover, the increasing regulatory focus on public companies in relation to the quality of their governance and the increasing presence of activist funds is driving minority investments towards public companies. Minority slates are becoming more and more appealing as a means to appoint directors in publicly listed companies.

Where the sponsor elects to make a direct investment in an Italian target company from another European jurisdiction the structuring considerations are driven by rules applicable to dividend stripping, capital gains tax and the applicable withholding tax regime. Investors should also consider that although Italian law provides for mergers between Italian and European companies (see Directive 2005/56/EC transposed into Italian law by Legislative Decree No. 108, 30 May 2008), in practice these mergers are far more burdensome and time-consuming than they appear at a first glance, thus making the merger of an Italian target with a leveraged SPV located abroad into a complex procedure.

ii The duration of the ‘representations and warranties’ in sale purchase agreements

One of the main debated issues in Italian M&A practice is the duration of ‘representations and warranties’ in sale purchase agreements. According to Article 1495 ICC, – which applies to the sale of ‘goods’ – the buyer can claim possible defects of the sold goods, within the statute of limitation of one year, and the parties cannot derogate the statute of limitation provided for by law. Though Article 1495 ICC applies to the sale of ‘goods’, the Italian courts, in the majority of their decisions, have interpreted it widely to apply it also to the sale of shareholdings. This interpretation is not consistent with M&A practice, where usually the parties agree on a longer duration that the one year provided for by Article 1495 ICC.

The decision of the Court of Cassation, 24 July 2014, No. 16963, has contested this approach. The Court of Cassation has stated that the one-year statute of limitation term is justified when referring to sales of goods, while in the sale of shareholdings the ordinary 10-year statute of limitation term should apply: the parties are therefore allowed to agree on a longer term than the one-year term provided for by Article 1495 ICC.

However, some decisions seem to have returned to the previous approach and, consequently, the scenario remains rather unclear. In any case, practitioners and scholars are continually striving to recommend new inputs on how to overcome these issues and the hope is that very soon the current uncertainty will be over.

iii Fiduciary duties and liabilities

The relationship between majority shareholders and minority shareholders is typically governed in the case of a private equity investment by a shareholders’ agreement.

This grants a direct contractual claim in case of breaches of contract to the non-defaulting party. Italian case law has recently disputed whether the judiciary system has forged an effective ‘abuse of majority’ principle (i.e., the use of legitimate rights to the deliberate detriment of

6 See ex multis, Court of Appeal of Milan, 21 November 2008; Court of Cassation, 20 February 2004, No. 3379.
7 Court of Cassation, 24 July 2014, No. 16963.
8 See Court of Cassation 6 November 2014, no. 23649; Court of Cassation 8 July 2015, No. 14255; Tribunal of Lucca 10 July 2015; Tribunal of Rome 28 September 2015.
minority shareholders) along the lines of the principle of ‘abuse of law’ widely adopted by tax authorities. At the time of writing, this principle is still evolving, and its use is limited to the more extreme cases of ‘abuse of majority’.9

Sponsors’ representation on the board of directors of Italian companies is certainly one of the most challenging aspects of private equity investment in Italy. Clearly, control of the majority of the board (typically attained with the direct presence of sponsors’ appointed directors) is the key to any majority designed investment. It has also become clear since the global financial crisis that individuals holding board positions in leveraged companies are at risk of considerable personal liability. Furthermore, this risk of liability may spill over to parent companies in cases where a clear legal line is not drawn between provisions that are in the best interest of the company and those that are the in the interests of the sponsor.

**General duties – duty of care and duty to act in an informed manner**

Directors have a general duty of care in managing the company (see Article 2392 ICC) and a general duty to act in an informed manner, examining the information received from executive directors and gathering directly the necessary information to supervise the company’s management (see Article 2381 ICC).

With particular regard to the general duty of care, in principle, the directors may not be held liable for the damages suffered by the company that occur as a direct result of erroneous business choices during the course of their management of the company. This is a direct application of the ‘business judgement rule’, which is often expressly stated in the decisions of courts.

In a situation of crisis these general duties must be respected with particular care, as it is likely that, in a subsequent insolvency procedure, a liability action will be pursued against the directors. In particular, once the directors are aware that a situation of distress exists, they should exercise their supervising duties and keep themselves constantly informed on how the crisis evolves, as well as making every reasonable effort to adopt appropriate measures to avoid or limit a further deterioration of the company’s status. To this end, if the directors feel uncomfortable acting on their own, their supervising duties allow for them to appoint professionals with specific competence and knowledge relevant to assisting them in ameliorating the crisis.

**Certain specific duties**

In addition to the general duty to act with care and in an informed manner, the ICC imposes certain specific duties on the directors.

- **a** to give effect to the legitimate shareholders’ resolutions;
- **b** to keep the company’s accounts correctly and draft the annual financial statements;
- **c** to keep the corporate books accurately as indicated by law;
- **d** to call a shareholders’ meeting at least once a year to approve the company’s financial statements;

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with respect to the managing director or directors and any executive committee (to the extent that such are in place), to inform the shareholders and the statutory auditors every six months of the general trend of the management and on its expected evolution as well as on the major transactions entered into by the company; and

not to carry out competing activities.

One specific situation worth mentioning where the duty of care enters into a critical phase is when a company enters negative equity. This status (which in certain instances might be the waiting room for an insolvency scenario) is viewed with particular disfavour in the Italian legal system, and the failure by the directors to cure it promptly may be the source of key arguments in liability actions.

**Liability actions against the non-executive directors**

Under Italian law the members of the board of directors may be subject to the following civil liabilities:

- **a** to the company, if they have not fulfilled with due care the duties imposed upon them by the law and by the company’s by-laws;
- **b** to the company’s creditors, if they have not fulfilled the obligations regarding the preservation of the integrity of the company’s assets; and
- **c** to the individual shareholders and third parties, if the latter have been directly damaged by negligent or fraudulent actions of the directors.

**Liability of the directors in the context of groups of companies**

In the context of groups of companies, the directors may be held liable – jointly with the controlling company and its directors – if they have put in place actions or transactions in the interests of the group, which have diminished the company’s assets, provided that the company has not received any immediate benefit from such actions or transactions. This type of liability has been triggered several times in the context of the insolvency of groups of companies, in cases where one of the companies belonging to the group that was in good standing has put in place actions to avoid or limit the crisis of another company belonging to the same group and, as a consequence, has ended up being involved in the crisis of the group. Notwithstanding such kind of liability has been provided for in the context of the 2003 reform of the ICC (and, therefore, it is not a recent one), there are still many issues under debate. Recent case law has however given some new inputs, and hopefully in the upcoming months a more stable approach will develop.¹⁰

Recent experience of private equity investments in Italy suggests that there are two major risks for sponsors in relation to investments made in Italian companies: the doctrine of parental liability and the doctrine of abuse of law, as detailed below.

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¹⁰ More in general, with respect to the liability in the context of group companies, see [ex multis](#), Court of Cassation, 13 February 2015, No. 2952; Court of Milan, 10 November 2014, in Società, 2015, p. 1377; Court of Mantova, 16 October 2014, in Società, 2015, p. 1405; Tribunal of Cagliari, 14 April 2011, in Giurisprudenza Commerciale, 2013, II, p. 687.
The doctrine of parental liability

The first risk relates to the ‘parental liability’ doctrine that has been developed by the European Commission in recent antitrust matters. According to this doctrine, where a number of entities are held liable for the participation of one undertaking in the infringement of competition law, the European antitrust authorities will tend to consider all of the entities as jointly and severally liable for that infringement together with the ultimate parent company that was directly or indirectly managing the infringing company (which may well be a portfolio company of a sponsor) at the time of the infringement. This doctrine, that has also been confirmed in a recent case, is far reaching, considering that it is also likely to be enforced by the national antitrust authorities of all European Union countries, and it is predicated to also apply to a parent company subsequent to the disposal of a subsidiary company that was held to be responsible at the time of contributing to the infringement of competition rules.

Considering the magnitude of the fines at stake in European antitrust matters (each undertaking participating in an infringement is liable to a fine of up to 10 per cent of its total turnover in the preceding business year, see Article 23(2) of Regulation No. 1/2003) it is clear that for sponsors, antitrust parent company liability is one of the largest liabilities that may pierce the corporate veil of special purpose acquisition vehicles in Italy (or for that matter in Europe). In order to minimise this risk, particular attention should be devoted by the sponsor to immediately setting up, right after the acquisition of a controlling stake, an appropriate compliance programme, which may be considered as a mitigating factor in parental liability cases. More substantially, prior to any majority investment it is advisable to perform in-depth economic and legal due diligence on the relevant market in order to assess if there is a concrete risk of a collusive or abusive anti-competitive behaviour. In order to avoid or at least mitigate this backdrop, the corporate governance structure that is adopted in the investment also plays a material role and the inherent tension between control and risk of parental liabilities should be moderated according to the specifics (including antitrust analysis) of any investment scenario.

The doctrine of abuse of law

The second risk relates to the doctrine of ‘abuse of law’, which was in origin developed by Italian tax authorities and upheld since 2008 in several final-instance court judgments. This doctrine was transposed into hard law by Legislative Decree No. 128 of 5 August 2015, which introduced into Law No. 212 of 27 July 2000 the new Article 10-bis, expressly providing for the power of Italian tax authorities to derecognise the tax-beneficial effects of those transactions that, though formally complying with tax law, do not have a recognised ‘valid economic rationale’ and are structured for the essential purpose of obtaining an undue tax advantage. The abuse of law principles, which are also supported by well-established case law, are

11 See Case C-97/08 Akzo Nobel NV and Others v. Commission and AT. Case 39610 / Power Cables.
12 See Case C- 597/13 P Total SA v. Commission.
13 See EU Case T-314/01 Awebe v. Commission.
14 However, see Case C-501/11 P Schindler Holding and Others v. Commission, where the Court of Justice said that ‘the implementation of [a] code of conduct suggests rather that the parent company did in fact supervise the commercial policy of its subsidiaries’.
15 See Court of Cassation 15 July 2015, No. 14761; Court of Cassation, 19 February 2014, No. 3938; 30 November 2011, No. 25537; 23 December 2008, Nos. 30055, 30056 and 30057.
Community law,¹⁶ pose a clear obstacle to the structuring of private equity investments and call for an increased use of Italian SPVs considering that is not always possible to justify (by transferring administrative or operational functions) the economic substance of SPVs based in different (and more tax advantageous) European jurisdictions.

III YEAR IN REVIEW

i Recent deal activity

A potent cocktail of political uncertainty, financial system weakness (in particular the concern about the bank Monte dei Paschi di Siena and other Italian banks) and the knock-on impact of ‘Brexit’,¹⁷ has surely affected the private equity industry in Italy.

However, the market in Italy has continued its trend towards consolidation, and Italian companies have not lost their appeal in the eyes of overseas and northern European investors, that still recognise the possibility of entering into attractive transactions in Italy compared with other European jurisdictions.

ii Financing

In 2016 senior debt is once again the most popular financing option (87.1 per cent of cases). This modality of financing is then followed, with a significant lower share (3.2 per cent overall), by the use of mezzanine financing and high-yield bonds. The share of investors mostly relying on commercial banks for their financial needs is slightly decreasing with respect to the first half of 2015 (from 70.3 per cent in 2015 to 64.5 per cent in 2016). While, investment banks and other financing sources are becoming more popular (respectively, +16.7 per cent and +4.3 per cent if compared with the first half of 2015).¹⁸

In addition, it is worth noting that Law Decree No. 18 of 14 February 2016 (as converted with amendments into Law No. 49 of 8 April 2016) has introduced Articles 46-bis and following in the Unified Financial Act, expressly envisaging the possibility of the Italian alternative investment funds to grant loans to entities other than consumers. In the upcoming months, we will see if operators will use this modality of financing.

iii Insurance

A significant development in the Italian private equity market is constituted by the increasing utilisation of ‘warranty and indemnity insurance’ (W&I) within the framework of acquisition transactions. In particular, the W&I are insurance policies that allow to shift the risk of breach of representations and warranties issued in the context of a sale and purchase agreement, from the seller to the insurance company. The most important advantages of the W&I with respect to the ordinary ‘representations and warranties of the seller’ are the following:

a the W&I may cover the risk for a longer period of time than the one agreed by the parties in the agreement. In this respect, the W&I can help to overcome the issues of the duration of the representation and warranties; and

b in case of a breach, the buyer can rely on the solvency of an insurance company, which is surely higher than the seller’s.

¹⁶ See EU Case C-255/02 Halifax.
IV REGULATORY DEVELOPMENTS

Legislative Decree No. 44 of 4 March 2014, implementing the European AIFMD (Alternative Investment Fund Managers Directive) in Italy, has reformed several provisions of the Unified Financial Act concerning the management, administration and marketing of alternative investment funds, including private equity funds. Nevertheless, such reform has not changed the regulatory bodies having oversight of the formation and activities of private equity funds in Italy, which continue to be the Bank of Italy and Consob (the public authority responsible for regulating the Italian securities market). Private equity funds based in Italy are typically managed by a registered asset management company, which must be previously authorised by, and registered with, the Bank of Italy after also receiving approval from Consob.

In particular, the above Decree has introduced a new kind of investment vehicle: the investment companies with fixed capital, the Sicaf. The Sicaf, whose capital structure is similar to the stock corporations, allows investors to take part in the decisions regarding investment strategies of the company, through the exercise of voting rights. It is worth noting that Sicaf, is permitted to raise funds not only by means of the issuance of shares, but also through the issuance of other financial participation instruments (excluding bonds), thus allowing the differentiation of duties and rights among the participants to the capital of the Sicaf.

Also under the new regulatory framework, private equity transactions continue to be subject to standard regulatory approvals (such as antitrust clearance) and specific regulatory clearances in regulated sectors (such as banking, insurance and energy).

Recent developments that may impact on private equity transactions have been introduced by Law Decree No. 91 of 24 June 2014 (as converted into law by Law No. 116 of 11 August 2014), and Legislative Decree No. 25 of 15 February 2016. These Decrees also amended certain provisions of the Unified Financial Act mainly relating to listed companies and, in particular, to the thresholds for compulsory public tender offers and the communication of significant interests.

i Thresholds for compulsory public tender offers

The amended Article 106 of the Unified Financial Act generally provides for an obligation to execute a public tender offer for any shareholder owning an interest or voting rights of more than 30 per cent of the corporate capital or the overall number of voting rights respectively. In respect of companies that are not SMEs, the public tender offer must also be promoted by any shareholder who becomes, following several transactions, owner of an interest equal to more than 25 per cent of the corporate capital, in the case of the absence of any other shareholder owning a majority interest. The by-laws of the listed SME can also provide for a different threshold for the above-mentioned compulsory public tender offer, provided that such threshold falls between 25 and 40 per cent. A regulation adopted by Consob specifies certain exemptions from the compulsory public tender offer.

ii Thresholds for communication of significant interests

The new formulation of Article 120 of the Unified Financial Act (as amended by Legislative Decree No. 25 of 15 February 2016) provides for an obligation for any shareholder owning an interest equal to 3 per cent of the corporate capital (and, specifically for the SMEs, 5 per cent) to inform the company and Consob of such interest. The law specifies that with reference
to companies having by-laws providing for shares with increased voting rights, the corporate capital must be deemed represented by the overall number of voting rights. A regulation adopted by Consob specifies the rules for the calculation of the interest.

V OUTLOOK

The full outlook for 2017 remains difficult to predict. A trend that we believe will be confirmed is the investment in medium-sized companies mainly still supported by financings provided by commercial banks. Although in past years a number of prominent private equity houses left the Italian market (and sometimes the European one as well), it is likely that other foreign private equity investors are monitoring the Italian market, attracted by the possibility of capitalising on transactions evaluated on the basis of lower multiples if compared with other European jurisdictions.
I OVERVIEW

Deal activity

Private equity deals in 2016 were almost the same level as in 2015 in respect of both volume and value. According to the Japan Buy-out Research Institute (JBORI) (the data in Section I.i and Section III.iv, infra depend on JBORI’s data), in recent years, there have been 50 to 70 deals with a total deal value of approximately US$4–5 billion each year. The value of the deals will significantly increase in 2017 because it has been announced that Kohlberg Kravis Roberts (KKR) will purchase Calsonic Kansei Corporation for approximately US$3.5 billion and Hitachi Koki Co, Ltd for approximately US$1.3 billion, both of which will close by the end of 2017. The current record-high year was 2007 in which 90 deals were completed with a total deal value of approximately US$5.5 billion, but if the two KKR transactions mentioned above are successfully completed, the value of the deals in 2017 could reach a new record high. The recent volume of deals is fuelled by continual active investments related to carve-out deals involving large companies that are in financial trouble and business succession involving small to mid-size companies and family-owned companies.

During the period from July 2015 to June 2016, there were four public-to-private deals, out of which two were small deals with a deal value of less than US$25 million, and the other two were mid-size deals with a deal value of approximately US$100 million and US$130 million, respectively. 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 last five years discourages them.

In recent years, there were approximately 40 to 50 exits in each year and during the period from January 2016 to June 2016, among all the private equity investment exits, trade sales and secondary buy-outs constitute approximately 80 per cent, IPOs constitute approximately 10 per cent and other exist constitute the remaining 10 per cent.

Quite a few private equity funds are active in Japan. The funds can be categorised thus: (1) independent domestic funds, (2) global funds and (3) funds managed by Japanese financial institutions or trading firms. The history of funds in Japan started with the independent domestic funds in the late 1990s, and since then many new funds have emerged every year while the early independent domestic funds, such as Advantage Partners and Unison Capital, are still very active. As to the global funds, many of them, such as Bain Capital, the Carlyle Group, KKR and Permira, are also active players in Japan.

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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 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 of qualified stock options include:

- a the commencement of an exercisable period no earlier than two years after the resolution to grant stock options and expiration prior to 10 years from such 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 such 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 such period can be shortened if the deal is apparently 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 such fund, in which case the domestic sales of such 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 ‘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 such period can be shortened to two weeks if the deal does not involve any 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 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 Regulations of the Relevant Stock Exchange have a large effect on investments by funds that involve a listed company. For example, (1) 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; (2) if the transaction involves a listed company, the stock exchange regulations will require the listed company to make a disclosure about the fund; and (3) 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 procedures in relation to the Antimonopoly Act and the FEFTA are as discussed in Section I.ii, supra.

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, thereby, the fund will directly hold 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., 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 a special class stock or stock consolidation. In order to accomplish such squeeze-out of minority shareholders, the SPC must secure two-thirds of the voting rights of the target company because such threshold is required to pass a special resolution at a shareholders meeting required for the squeeze-out process. As a result of 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. Under such call option, if the SPC has obtained 90 per cent or more of the voting rights as a result of the first-step TOB, the SPC is able to squeeze out the remaining minority shareholders without a shareholders’ meeting and only by exercising the statutory call option right against such remaining shareholders.

Finally, a cash-out merger has not been used for squeeze-outs because it has not been tax efficient in most cases. However, the Ministry of Finance recently announced a proposed draft amendment to the Corporation Tax Act that, if adopted, will come into effect some time in 2017. If it is adopted, such amendment will make a cash-out merger more tax efficient when the surviving company holds two-thirds of the voting rights of the absorbed company. As such, we expect that the cash-out merger structure will be widely used for the second-step squeeze-out process after the amendment to the Corporation Tax Act comes into effect.

Fiduciary duties and liabilities

Directors

A fund’s portfolio companies (each, a ‘company’) overwhelmingly take the form of joint-stock companies. The directors of each such company appointed by a fund as its representative on the board owe a duty of due care and a duty of loyalty to the company under the Companies Act. Namely, they have a duty to the company, in performing their duties, to use the due care of a good manager. They must comply with all laws and regulations and the company’s articles of incorporation (AOI), as well as all resolutions adopted at general meetings of shareholders, 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, such director will be liable to such 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 judgment rule in the US. However, it differs from the US business judgment 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, which 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 exist minority shareholders. Although some scholars suggest 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 duty. No courts, to date, have so ruled, and the above scholars’ 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.

As opposed 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 procures 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 it tries to include protective provisions in the agreement to limit its liabilities.

**III YEAR IN REVIEW**

i **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 for such exceptional transactions, only the basic terms and conditions are disclosed, which unfortunately give little information to analyse the trends of terms and conditions of private equity deals unlike in certain other countries, such as the United States, where listed companies must make more detailed disclosures of the M&A agreements entered into by such companies. 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.

However, there was 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 (‘squeeze-out price’). Generally,
in past similar litigations, 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, which adjustment mechanism was 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 the case where a conflict-of-interest situation, such as an acquisition of the target company by the parent company as in this case, exists, as long as the tender offer was conducted under a fair procedure that is generally accepted, 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 2016, Japanese lenders have continued to be active in providing acquisition finance, which is attractive to them due to the generally higher spreads. A new development is that, as Japanese companies’ interests shift to outbound acquisitions behind a shrinking domestic market due to a declining and aging population, Japanese lenders are becoming more active in providing financing for cross-border acquisitions, which 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. This trend 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., the Bank of Tokyo-Mitsubishi UFJ, 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
The 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 phenomenon 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, that no price adjustment mechanism is included in a stock purchase agreement for sale of a non-listed company. In such case, 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, though the trend may change in the future.

On the other hand, especially for large volume deals or deals in which the period between the execution of the definitive agreement and closing is expected to be lengthy due to various reasons, such as the antitrust clearance process, purchase price adjustment mechanisms are frequently used. In such case, a closing account is prepared and, typically, the difference of the net-debt and working capital between the base date and the closing date is adjusted. Recently, however, especially in the auction process, the seller often strongly 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 the number of actual issuances of representation and warranty insurance are said to be less than 20 a year. 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 to take 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 due to 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, precedents 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 entail 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 tender offer due to 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, no default cases due to such a financing failure have yet occurred in Japan.

**iv  Exits**

For the last few years, 40 to 50 exits occur annually. Approximately 80 per cent of the exits are achieved by way of a trade sale including a secondary buyout. In 2016, four 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 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, supra, various regulations may apply to each PE transaction or to PE sponsors’ activities.
V OUTLOOK

In 2017, it is expected that the general trends described in Section I above will continue. Mid- to small-cap transactions will be the overwhelming majority of deals in 2017 while there could be some mega deals, including the two large deals by KKR already announced, and investments involving business succession of small to mid-size companies will continue to be very active. Due to the expectation that there will be fewer mid- to large-size transactions in 2017 while financing is available, it is expected that secondary buyout transactions will also become more active in 2017.
Chapter 15

LUXEMBOURG

Alexandrine Armstrong-Cerfontaine

I OVERVIEW

i Deal activity

2015 was generally a strong year for European private equity deal activity, but there was a slight fall in the number of deals compared to 2014. Based on Preqin’s 2016 Global Private Equity and Venture Capital Report, the key takeaways for 2015, felt in Luxembourg due to the number of private equity sponsors based in Luxembourg and the vast number of acquisition special purpose vehicles based in Luxembourg, are as follows: 3,556 deals took place in 2015, in line with the average number of deals since 2011 (on average, 3,660 per year); and 2015 saw a strong increase in deal value compared with 2014 (an aggregate amount of US$411 billion), showing a continued increase for the last four years, but this level remains far behind 2007 (US$694 billion).

Exits were dominated by corporates, with a slight reduction of IPOs and secondary buy-outs. Interest from Chinese corporates in European assets were at an all-time high in 2015. HNA Group Co’s interest in Swissport, the sale of Vistra and Orangefield to Baring, the acquisition by Jianguang Asset Management of NXP’s radio frequency arm are examples of Chinese investors’ hunger for European assets.

ii Operation of the market

Sponsors rely on the expertise of key managers to leverage on their knowledge of the industry and market in which they invest. Incentivising the management team brings management’s interest further in line with the interest of the sponsor. Management often takes a participation in the Luxembourg holding company or the Luxembourg subsidiary of that company, directly or through a management company, a pooling vehicle that ensures control of the sponsor over the participations held by managers and facilitates the exit process for those managers who are leavers prior to the sale of the portfolio company. The form of the investment is assessed in light of the equity structure of the Luxembourg entity and the location of each of the managers as the jurisdiction in which they are employed may trigger specific tax, employment and pension liabilities. Employment law in the jurisdiction of the majority of the management team impacts on the fine tuning of the good-leaver or bad-leaver provisions. In a nutshell, the structure and form of the investment of key managers is tailor-made to reflect the agreed business plan, the type of acquisition of the sponsor, the

1 Alexandrine Armstrong-Cerfontaine, who was a managing partner at King & Wood Mallesons when she wrote this chapter, is a consultant at Goodwin Procter LLP. The information in this chapter was accurate as of March 2016.
composition of the management team (short tail or long tail, level of seniority, multi-tier structure, etc.) and the location of the majority of the management team. With the risk of over-simplification due to the diversity of management incentive plans implemented in Luxembourg, the sponsor will invest in shares representing the majority of the share capital of the company (and, in many cases, other instruments) of a certain class and management will invest in other shares, quasi-equity instruments or debt instruments of another class representing part of the roll-over consideration, and which will represent a minority of the share capital of the company on a fully diluted basis, and additional instruments (shares, quasi-equity instruments or debt instruments) being ’sweet equity’ with payment of proceeds on that instrument if certain internal rates of return and, where applicable for short-term investments, agreed money multiples thresholds are achieved by the time the sponsor exits. If quasi-equity or debt instruments are issued, a waterfall is as standard complemented with a subordination arrangement on the debt instruments prior to the payment of the shares with a different rate of return, on a pari passu basis.

A sale process very much depends on the particular context in which the target investment evolves and on the type of purchaser. While 2015 was a very competitive year, the focus of sellers remained on conditionality and the certainty of funds. Furthermore, the process of a sale with a corporate purchaser, which is a strategic buyer, very much focuses on the synergies between businesses, the ownership structure of the target, its governance and ultimately the composition of the management team (thus altering incentive arrangements). There is no definite timeline or average duration for sale processes, though it is fair to say that the negotiation process with investors based in Asia usually takes a little longer than with other purchasers.

II  LEGAL FRAMEWORK

i  Acquisition of control and minority interests

The key terms of the sponsors’ investment address control over management and control over the exit process, potential transfers and the syndication of the sponsor’s participation in the portfolio company are in the articles of association of the company and in a shareholders agreement. There is no standard. The main characteristics of the provisions relate to the control over the operations of the portfolio company (if based in Luxembourg) and the Luxembourg holding company in its own capacity and as shareholder of the portfolio company. As such, while the board has control and responsibility for all matters relating to the company, certain important shareholder and business matters in relation to the company and each member of the group are reserved for the approval of the general meeting, with voting rights for such meetings organised to ensure control by the sponsor. Financial thresholds that apply in relation to some of the consent matters, and whether additional consent matters are required are deal specific. For the avoidance of doubt, other than the sponsors, the shareholders would not typically be given any veto rights. The same applies to majority requirements at board level, where the sponsor has a seat, if not the majority of seats (depending on the size of the sponsor’s investment). The precise rights given to the sponsor are always carefully discussed on a deal-by-deal basis to ensure that the optimal balance is achieved between protecting the sponsor and allowing efficient management of the business.

The shareholders agreement and the articles of association of the company typically provide for various scenarios of exit within a set timeframe. The sponsor will be able to offer up to 100 per cent of the company to a purchaser. It will therefore require ‘drag-along’ rights
enabling it to force other shareholders to sell their shares to a third party in the event that those other shareholders are not willing sellers; however, sponsors – and purchasers – prefer consensual exits, and drag-along rights are generally only used as a last resort. The sponsor will usually be entitled to determine the form of consideration (i.e., cash, non-cash, deferred, etc.) and, in some cases, determine that management (minority shareholder) is required to take a roll-over alternative. The flipside to this arrangement provides that if a sponsor wishes to transfer its participation in the portfolio company or holding company, such transfer may only be made if the proposed transferee has made an offer to buy a proportionate part of the participation of the minority shareholders, on the same terms as for the acquisition of the instruments held by the sponsor. As investments in Luxembourg are most often a mix of various instruments, this requires that they are stapled to ensure that the capital structure and tax integrity of the structure are preserved.

While the structure of the capital of the Luxembourg company varies in consideration of the location of the sponsor and the location of the portfolio company, the standard structure involves at least one Luxembourg holding company through which investments by the sponsor will be made and a subsidiary usually based in Luxembourg to address security and intercreditor arrangements required with the financing of the acquisition and ring fencing. The capital structure is driven by both the size of the acquisition and by tax, where particular attention is given to the substance of the Luxembourg company.

As regards the share purchase agreement, the standard representations and warranties protecting the sponsor include:

a the organisation of the target and its ownership;
b the target’s capitalisation (equity and shareholder debt, if any);
c legal and regulatory compliance;
d the target’s financial position (particularly the accuracy of the accounts on which the purchase price is based);
e important contracts relating to the business of the target;
f litigation; and
g employment.

Lock box arrangements are much less common since the financial crisis. Earn-out provisions are now the reference with a preference to make a substantial part of the purchase price dependent on the target’s financial performance after closing.

ii Fiduciary duties and liabilities

No duty is owed by a sponsor towards other shareholders having a participation in a portfolio company. Obligations of shareholders towards each other are of a contractual nature and agreed in a shareholders agreement or the articles of association of the Luxembourg company in which they have a participation, or both. The most common cases where a conflict may arise between shareholders are those where amendments to articles of association are considered in preparation of an exit. Key managers of the portfolio company commonly hold shares and the economic rights attached to those shares have, in some cases, to be changed, or triggers for redemption or transfers must be amended. Rights attached to the shares of minority shareholders (e.g., drag-along rights) have to be reassessed as part of the preparation for the exit of the sponsor. If management or a minority shareholder hold a specific class of shares, any change that impacts on the rights attached to such shares will require their consent, with a majority threshold as set out in the Luxembourg Act on Commercial Companies of
10 August 1915, as amended (the Companies Act). As a rule, abuse of minority shareholders may only occur if the decision by the general meeting is contrary to the interests of the minority shareholder and with the view only to favour the interests of majority shareholders at the expense of minority shareholders. This means that the burden of proof is high as minority shareholders must evidence that the decision taken at the general meeting was taken against the corporate interest, with one goal only: the protection of the interest of majority shareholders.

There are no published judgments specifically on a sponsor’s liability towards a portfolio company. There is no obligation to fund a company. Such case may be raised by creditors in the case of insolvency, assuming that the actions of the sponsor as a shareholder of the company would constitute fraudulent conveyance. The burden of proof, in such case, would be high as the plaintiff would have to evidence a fraud on creditors from the company and the complicity of the sponsor as a shareholder of the ailing company. An action in tort may also be possible, to the extent that evidence would be established of the defective behaviour of the sponsor and the causation with the prejudice suffered by the claimant, such loss being different to that of the company.

Sponsors always nominate one or more board members in the portfolio company in which they invest, as well as in any Luxembourg-based holding company through which they make their investment into the portfolio company. The individuals are usually employees of the private equity firm who have participated in the acquisition process and will monitor the performance of the portfolio company, thus representing the interests of the sponsor. They may also be Luxembourg-based independent directors, appointed as board members and representative of the sponsor. In this context, such board members may be exposed to a potential conflict of interests and a breach of their duty to keep certain matters relating to the operation of the company confidential, the latter being typically addressed in the shareholders’ agreement with express consent from all shareholders on confidentiality and reporting to the sponsor. The key point is, always, for such board members to exercise independent judgment, taking into consideration the existence of separate legal entities and the duties of board members that are due to the company (i.e., to stakeholders taken as a whole, as opposed to the sponsor they represent). In Luxembourg, boards are, subject to certain exceptions, typically composed with half of the directors being based in Luxembourg and the other half from the jurisdiction of the sponsor and, where applicable, the minority investor. The nomination of independent directors addresses, in part, conflict issues up to the exit of the investment, though particular attention is required for individuals with mandates all along the chain of ownership: potential conflicts issues are not dealt with if the same individuals sit at the board of the Luxembourg holding company and at the board of the portfolio company, or at the board of the sponsor’s GP and at the board of the Luxembourg company, etc.

The sponsor’s representative, appointed by the general meeting of the Luxembourg company, owes fiduciary duties towards the Luxembourg company. As a rule, any board member having a personal interest in a transaction submitted for approval to the board conflicting with that of the company, shall be obliged to advise the board and to cause a record of his, her or its statement, to be included in the minutes of the meeting. He, she or it may not take part in the relevant deliberations. At the following general meeting of shareholders, before any other resolution is put to vote, a special report shall be made on any transactions in which any of the managers may have had an interest conflicting with that of the company and a shareholders’ resolution shall be passed in respect of such transaction. However, this
process will not apply if the transactions of the board of managers or of the manager relate to regular transactions concluded in normal market conditions. In other words, the assessment of potential conflict of interests between the company and the representative of the sponsor boils down to the assessment of the matter in light of the best interests of the company, which is a question of fact based on the circumstances when the action is taken.

The liability of a board member for ordinary misconduct of management is governed by the common rules on agency: the agent may not exceed his, her or its authority. The agent is liable for fraud and breaches committed in performing his, her or its management duties and if different agents have been appointed, they are not severally liable, except if otherwise provided for. Board members are liable towards the company, in accordance with the law, for the performance of the mandate conferred on them and for any misconduct in the management of the company’s affairs. Board members are jointly and severally liable both towards the company and any third parties for losses resulting from the violation of the law on commercial companies or of the articles of association of the company. A board member may be personally released of his, her or its liability if he she or it proves that they did not take part in the alleged breach, and that it reports such violation at the first general meeting. In practice, this means that an abstention to vote does not always suffice for board members to avoid a potential liability for decisions taken against the interest of the company.

III YEAR IN REVIEW

i Recent deal activity

As previously mentioned, 2015 was a good year for European private equity deal activity, with a little less deals but a strong increase in value. Buyouts were, last year as for 2014, the highest volume sector. Many of the largest deals of the year had a Luxembourg component. Looking more closely at the acquisition of Luxembourg targets, we witness a strong appetite for operational companies in the financial and trust services, insurance, fintech, luxury brands, pharmaceutical, and retirement sectors. In Luxembourg, auctions are common even for smaller and medium-sized buyouts – auctions are not specifically regulated, but competition law is always considered. The acquisition by Astorg of the SG group is the most recent example of a sponsor’s investment in a professional of the financial sector.

Overall, 2015 has been an eventful year for the private equity, especially for UK-based executives, or those with a legal or compliance role. The tax, legal and regulatory landscapes shifted significantly for European private equity and venture capital fund managers and investors in 2015. But it has also been a strong year for fund raising and there are some positives to take from various initiatives at a European level. 2016 may see more clarity on how non-EU funds and managers will be able to access the AIFMD and its marketing passport, and could bring further helpful initiatives as the European Commission continues its bid for a Capital Markets Union, but there are undoubtedly still clouds on the horizon, and this, together with the OECD’s BEPS initiative and in particular, interest deductibility, will define the contours of structures set up for future acquisitions.

ii Financing

Third-party debt financing for Luxembourg private equity transactions is largely made available in the form of senior debt and to a lesser extent mezzanine finance. There are many sources of credit available. Third party financings usually take the form of senior or mezzanine loans (syndicated or otherwise) and credit is now much more available and with a trend for
covenant-lite financings, from European banks and US banks. Mezzanine finance is to a large extent sourced from specialised mezzanine-debt funds. Stapled financing may also be put into place by the seller, but it is less common. Debt volumes have increased significantly over the last two years and unitranche financings granted by debt funds or certain direct lenders as an alternative to senior or mezzanine debt are increasingly common.

There is a clear shift towards debts funds as senior finance providers, including for larger transactions. Senior debt was, and continues to be, made available by banks, though debt funds were financed and continue to fund small to mid-size loans (up to €200 million) on a stand-alone basis. Since 2015, there is a positioning of debt funds for larger financings as they now form syndicates capable of financing large-cap transactions (over €500 million). Bridges continue to be built between private equity firms and debt funds (as well as between some banks and debt funds) for financing acquisitions and for add-on acquisitions, which is attractive to private equity firms diversifying their lender base. It would seem that debt funds will be increasingly present in the leveraged finance sphere, perhaps at the expense of traditional lenders. This is because debt funds, which are less exposed to market and regulatory pressures, can offer more attractive terms than banks. Covenant loose or covenant lite terms, more common for high yield financings, are standard for loans granted by debt funds.

High-yield bond issues are also an option as parties enjoy a relatively large degree of freedom in their terms and conditions. They became a common source of financing for corporates acquired by private equity sponsors, for amounts as little as €200 million, generally for bolt-ons and refinancings. While they are work-intensive and do not secure the confidentiality of information that is standard in a loan agreement, they provided access to capital when standard sources of financing dried up during the financial crisis, benefiting, in the case of refinancing, from a standard leveraged loan. Debt funds’ financings do not include market flex and provide for a large headroom for financial covenants, generous rights to cure and little or no mandatory amortisation, and their financings are becoming ever more competitive with other sources of debt finance. Their presence on the leveraged finance market will increase, and the pace of their progress will, in part, depend on the liquidity in the high-yield market.

Super senior financings have become common, ensuring that the super senior lenders are paid first when the security is enforced or when the debt matures, or on maturity. The As a standard, super senior debt also includes minimal financial covenant protection and protection against disposals or other transactions to secure sufficient income to service their debt. There is no market standard for such financings, which depend on the context of the transaction and the size of that debt relative to the overall capital structure. The waterfall priority of the super senior lenders will, as a standard, be addressed in an intercreditor agreement when the super senior facility is granted alongside a bond issue. When the super senior debt is made available with term loans, the specific rights of the super senior lenders, including enforcement rights for super senior lenders where the borrower does not repay the super senior debt or becomes insolvent, are included in a combined facility agreement.

Regarding the structuring of the financing of an acquisition, the current themes are very much the same over the last years, but with different variations depending on the jurisdictions involved with the cross-border financing. For both bank and bond financings, lending restrictions, limitations on guarantees and security that may be granted by a Luxembourg entity, hardening periods, the assessment of the security package to provide the fullest possible security cover, the assessment of potential withholding tax issues, thin capitalisation issues and financial assistance, are always subject to review. What has changed in the last three years
Luxembourg

(and will not return) is the double-luxco structure for French acquisitions (originally put into place to defeat France’s pro-debtors approach to ailing businesses). More generally, the double or triple holding vehicles put into place in Luxembourg for an acquisition in another European country are carefully thought through due to tax reforms or tax practices in some jurisdictions, including Luxembourg.

Tax and substance issues are key terms in any financings involving a Luxembourg obligor. This is reflected in the representations and undertakings which take into consideration the place of the central administration, the principal place of business and the centre of main interests of a Luxembourg obligor, essential to assess the rights of lenders in case of insolvency and the ability for the borrowing group to upstream cash, thus servicing the debt. Particular care is given to the structure of the transaction and specific representations and undertakings are designed to secure, to the maximum possible extent, that the central administration of the Luxembourg obligor remains in Luxembourg. Furthermore, the assessment of the substance of the Luxembourg obligor, from a tax perspective, is necessary to assess potential tax issues that the borrower group may incur should such substance requirement fail to be satisfied as this could have a material adverse effect on the debt coverage ratio, ultimately reducing the borrower’s net operating income.

iii Key terms of recent control transactions

There has not been much change to terms this year. It is worth remembering that sponsors focus on the agreement in full for the financing of the acquisition so that, when they sign the share purchase agreement, they have certainty of funding. Certain funds in the financing arrangement means that funding will be implemented subject to the compliance with representations and covenants under the sponsor’s control (i.e., on the borrower’s status and capacity). The flipside means that no waiver to conditions precedents to closing and material adverse change under the share purchase agreement may be waived without lender consent. Broadly, lenders can, therefore, walk away if the sponsor can walk away. As sellers want certainty, the negotiation of the MAC clause is tight when included in the share purchase agreement. For Luxembourg, drafting of such clause is key as Luxembourg courts would invalidate any condition in a contract in favour of a party who has the power to trigger that condition. A common way to address this, as sellers want to avoid conditionality and there is much competition for assets, is to provide a narrow list of events where the purchase can walk away and a list of events that would trigger an adjustment of the purchase price.

iv Exits

2015 was perceived locally as the year of big deals, with a widespread geographical cover. Private equity backed exits in 2015 surpassed the excellent records of 2014 for European buy-out exits, with trade sales being at the core of the largest exits. For instance, Altice SA, a Luxembourg-based cable and mobile phone operator, acquired a controlling stake in Suddenlink Communications for US$9.1 billion. A large number of partial exits were completed as GPs were looking to exit deals completed prior to 2007–2008, waiting for improved conditions for the sale and allowing them to return. While the number of deals decreased in comparison with 2014, the aggregated deal value increased in 2015. The number of restructurings and IPOs fell over the last year, though Worldpay IPO was the largest flotation on the LSE this year.
IV REGULATORY DEVELOPMENTS

The oversight of the activities of a private equity fund based in Luxembourg is done by the CSSF if the fund is a regulated entity or if the fund is an unregulated entity (such as a limited partnership, for instance) that is managed by an alternative investment fund manager based in Luxembourg and authorised by the Commission de Surveillance du Secteur Financier (CSSF). In very general terms, the management of investment funds in Luxembourg is regulated by the Law of 17 December 2010 on Undertakings for Collective Investments (the UCI Law) and the Law of 12 July 2013 on Alternative Investment Fund Managers (the AIFM Law), implementing Directive 2011/61/EU on alternative investment fund managers (AIFMD). With this reform, fund administration has taken a much greater role and the supervision of the activities of funds is made through their manager. The CSSF is the authority in charge of regulating funds and fund managers based in Luxembourg. With respect to alternative investment funds managers (AIFMs), the process of authorisation and supervision is conducted by the authority where the AIFM is located (i.e., the CSSF for any AIFM based in Luxembourg, ergo, unregulated funds based in Luxembourg which appoint an AIFM based in another European country will, in practice, be supervised through the regulator based in the country of the AIFM, as the AIFM must ensure that the fund is managed in compliance with the AIFM Law). This also means that regulated funds are supervised both by the CSSF and by the authority supervising the AIFM based in another European country that manages such funds, this in turn ensures that such regulated AIFs comply with the AIFM Law product rules, creating a double layer of supervision.

This will change when the Bill of Law 6929 regarding reserved alternative investment funds (RAIFs) is enacted, as Luxembourg-regulated or unregulated AIFs opting for such regime will be supervised through their AIFM (ensuring compliance by the AIF with the AIFMD) itself supervised by the regulator where the AIFM is located.

Regarding the conditions for approval of transactions of private equity firms, Luxembourg is a very open market and there is no approval to be obtained prior to an acquisition or exit of an unregulated business. For acquisitions of Luxembourg entities regulated and supervised by the CSSF, the latter must be informed of the identity of the direct and indirect new shareholders that have qualifying holdings and the amounts of those holdings. In short, the CSSF will need to be satisfied as to the suitability of the purchaser (good reputation, adequate professional experience, etc) and approve the business plan. Shareholders have to prove honesty, integrity and transparency, as well as sufficient financial solidify to ensure the long-term equity needs of the regulated target will be met. Potential conflicts of interests also have to be tackled when authorisation is requested from the CSSF. Qualifying holdings are deemed to be holdings of 10 per cent or more of the capital or voting rights or holdings that make it possible to either directly or indirectly exercise significant influence. In practice, the process is smooth and prompt. An equivalent process must be completed for targets in the insurance sector, regulated by and under the supervision of the Luxembourg regulator in the insurance sector.

V OUTLOOK

There is an unprecedented amount of dry powder for investments by private equity firms, which makes competition for assets intense. Firms must keep pace with investments as income is generated both by management fees and investments. Luxembourg should, therefore, see greater activity in 2016 as many acquisition structures flow through Luxembourg and many
funds are based in Luxembourg. The global amount of dry powder exceeds US$1.14 trillion (according to Preqin). However, the powder may stay a little dry in 2016 as the European economic landscape remains challenging, prices are high for European assets and the European regulatory landscape remains uncertain: many measures to kick-start the European economy are still in an embryonic stage.

The industry will have to follow the proposals on treaty abuse and interest deductions, as part of the OECD’s wide-ranging ‘BEPS’ initiative. The OECD’s final report published in October 2015 included rules to prevent multinational organisations from financing entities located in high-tax jurisdictions with high interest loans from group entities based in low-tax jurisdictions. In January 2016 the European Commission responded to the OECD proposals with a draft Anti-Tax Avoidance Directive, which proposed, as a minimum, that borrowing costs would be deductible up to the higher of 30 per cent of EBITDA or €1 million. In the event that these rules are adopted, EU Member States would be obliged to implement the Commission’s Directive, though they would be able to choose a threshold lower (and therefore more restrictive) than 30 per cent.

New rules on remuneration could also bring concerns to the industry. The issue of remuneration under AIFMD, which was thought to have been settled, reappeared during the summer, as a consultation was launched on remuneration under UCITS V and AIFMD. ESMA released a consultation paper in July 2015 on its guidelines on remunerations under the UCITS and AIFM directives. As regards the application of remuneration rules to third-party service providers acting as delegates (common in Luxembourg), management companies must be satisfied that delegatees are subject to requirements equally as effective as those applied in the guidelines. In Luxembourg, the current pragmatic approach is to rely on the equivalence between the AIFMD, CRD IV and UCITS V with respect to the remuneration of managers and their delegatees regulated under AIFMD, CRD IV or UCITS V.

However, the biggest roadblock is the referendum on the UK’s membership of the EU. Nobody can predict what life without the UK would be, but undoubtedly, a prolonged period of uncertainty is likely to create havoc for investments into and out of the UK, thus creating uncertainty around potential new deals in the most active region in Europe for PE, which in turn will have an impact on deal flow in Luxembourg.
Chapter 16

MEXICO

Andrés Nieto Sánchez de Tagle

I OVERVIEW

Deal activity

Private equity in Mexico is focused on investment in primarily small and mid-sized companies that are not traded in 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 in 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 of family-run companies. These perspectives, among other factors, mean that private equity in Mexico has less importance than it has in other emerging countries.

One noteworthy reason for resistance to private equity in Mexico has been the lack of competitive markets. According to an OECD study, prices in the country have been 40 per cent higher than they would have been in a competitive market. Consequently, during recent years, Mexican authorities have worked on creating regulations to make the country more competitive, and to strengthen and promote the growth of private investment, both national and foreign, in sectors to which it did not previously have access. The government's support of investments is already showing results and giving Mexico an advantage compared with other emerging market peers.

While this can be seen in both the opening up of the energy sector to private investment, as explained later, and the creation of public funds to encourage the development of small and mid-sized companies, one of the primary challenges private equity is facing is the reluctance of entrepreneurs and families managing many of the companies in Mexico to surrender control of their companies, and to accept external investment by capital funds as partners or shareholders. Despite this adverse 'cultural' issue, private equity has been gradually and rapidly gaining relevance in the country in the past few years.

For example, fundraising activities have been increasing since 2009, when the government allowed retirement fund administrators to invest in private equity vehicles. According to EMPEA's special report on private equity in Mexico, fundraising for Mexico-dedicated vehicles has grown from US$574 million in 2009 to US$2.1 billion in 2015. 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

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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 end of the state monopoly in this sector with the 2013 energy reform and the new regulations that have been issued have opened the sector to private investment, allowing Mexico to become an attractive market for private equity.

Apart from the well-known energy sector, other sectors such as fintech, 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. In this sense, according to Luis Videgaray, former Treasury and Public Credit Minister, a reform regarding fintech was planned for 2016. For the moment, however, Mexico still lacks a legal framework in this matter, although it is expected at any time. This is also the case for crowdfunding. Since fintech is already important for private equity and the government is boosting national and international investments, we look forward to regulation of the fintech sector, which might increase activity levels, or at least provide certainty for investors.

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 also continues to grow because of the exit options, which are expected to increase in the next few years. From 2000 until now, private equity in Mexico has accumulated more than US$30 billion. 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 do not have specific supervision or treatment under the law, although certain acts require regulatory compliance, and tax issues must be addressed carefully because of the nature of these operations. Nonetheless, every financial player 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. The main challenges for legal advisers in Mexico in the area of private equity is knowing and understanding the needs of all the practices and subjects involved in private equity transactions. In this regard, legal advisers must know the practices and the legal structure of private equity investors, as well as being familiar with the company culture in Mexico. As previously mentioned, many Mexican enterprises are family
businesses that tend to be reluctant to surrender control of their companies. There are also various challenges to be overcome in an international transaction that can have implications in 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:

- contributions of capital from their partners or shareholders;
- financing by the government;
- 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 that make it possible to carry out these types of transactions, and the time it takes depends on the complexity of each transaction.

Regarding private equity, Mexico’s industry is basically composed of funds with different investment strategies. Generally speaking, there are four types of funds. The first type is private equity funds, which normally function with one of the following investment strategies:

- growth, investing in companies that are looking for expansion, entering new markets or financing a strategic acquisition;
- leveraged buyouts, specialised in acquiring companies via external capital;
- mezzanine capital, which allows for more flexibility as less guarantees are required (meaning more risk and higher costs); or
- distressed or special situations, which invest in companies or assets that are facing difficult situations.

The second type of funds, venture capital funds, seek to invest in companies in their early stages, known as start-ups. The third type of fund invests specifically in real estate for residential, tourist, commercial or industrial use. Finally, the fourth type of fund specialises in infrastructure for transport, energy or other sectors.

Normally, to create a private equity fund, there are several steps to follow. First, the investors interested in creating the fund should form a team to identify, give structure to and plan the process for investment and exit or disinvestment. In other words, the assigned people need to establish a clear investment strategy, which will vary depending on, inter alia, the investment strategy or goal, the sector and participants, as previously explained. 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 fund’s size and sector); carried interest or carry returns that correspond to the fund administrator; and other sources.

Once the goals are established, the team to achieve them appointed and the internal financing scheme settled, the second step is fundraising. This step is usually fairly complicated and might take a long time. In this sense, different scenarios must be considered in the
planning phase in the event that goals are not reached within the planned periods of time. It implies a process of advertising and selling to investors (nature persons, corporations, other funds, etc.), and the administrator of the fund is in charge of this process.

Once the fund has gained the commitment of the necessary investors, it can then continue with the third step: the legal formalisation of the work done to date. This means, basically, incorporating the fund operator and the investment vehicle. The structure will vary, again, depending on a fairly large number of factors. This step is explained in Section II, infra.

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 terms page in the event that it is all found to be satisfactory.

The due diligence consists of, among many other factors, a strategic analysis of a 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 is a key step to make a good informed decision. By means of the due diligence, the administrator should have a clear overall picture of the company, the market in which it competes, its needs, the risks it is facing, 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, and its businesses and permits. 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 terms page, 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 company’s operation. 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 on the company – in short, whatever is deemed to be required, always keeping in mind the common goal: that of increasing the company’s value as much as possible within a given period of time.

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. This process and its options are analysed further below.

A key factor in the whole process is that, to achieve all of the above-mentioned, funds must obviously be run correctly. In this sense, investors in private equity funds have the most important role as controlling agents. Therefore, the investors and the fund meet regularly, and the investors receive reports at established intervals and undertake 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 depend 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, which are legal instruments that allow asset managers to channel the resources of pension funds (Afores, which were only legally able to invest in publicly offered securities) into projects. Hence, via 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. Besides CKDs, which have been successful, generating a total of 191,247 million Mexican pesos in 2015, there have been other legal developments in favour of private equity. This is the case of CerPIs and Fibra E (see Section IV, infra).

To create a fund, as detailed in Section I, supra, the third step in the process 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 these vehicles are:

a limited partnerships (similar to the Mexican sociedad comandita por acciones);
b private equity investment trusts (FICAP), whose purpose is to invest, or that are finance companies not listed in the Mexican stock exchange for a maximum period of 10 years;
c non-business trusts, which have less restrictions than a FICAP; and
d capital investment companies, which might be inefficient for certain purposes due to their 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 need to assure 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 holds on his or her side.

A consideration before investing is making clear the limitations applicable to foreigners. According to the Foreign Investment Law, foreigners have 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, we need to clarify that Mexico is a fairly open market, and the aforementioned in fact implies very few and specific restrictions. As previously mentioned, all regulation is built with the specific intent of facilitating foreign investment into the country. It is worth noting that Mexico has many commercial treaties and agreements with other countries, and the trend is to keep it that way.
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 that 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-case and probably never-desired scenario, a liquidation. The structuring considerations will depend on many factors, and every deal will be unique. What is really important and common to all deals is bearing in mind that time is of the essence, and requirements need to be very carefully considered to avoid problems and misunderstandings; in addition, a disinvestment operation might take quite a long time.

Considerations for foreign investors might arise precisely 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 among several parties, which always results in more time and money being expended. Otherwise, as previously mentioned, other than some tax considerations, Mexico is a fairly straightforward and dynamic country in which to invest and disinvest.

III YEAR IN REVIEW
During 2015, two deals stood out. A fund named Credit Suisse Mexico Credit Opportunities Trust II and managed by Credit Suisse Emerging Markets Credit Opportunities (EMCO) raised US$751 million. This fund was created regarding diversified private credit. RIVERCK 15, managed by Riverstone Holdings, raised US$733. RIVERCK 15 was a fund created for the acquisition of real estate assets. These two correspond to the second and third-largest Mexico-dedicated funds up to December 2015. By the end of 2016, some private equity firms, such as Alsis Funds, focused their investments in Mexico in the real estate housing sector. This fund stated that in 2017, its plan is to invest in about 25 projects.

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 2014 focused majorly on electronic commerce, telecommunications and financial services. However, as previously mentioned, two more sectors are now gaining more investment: health, and consumer goods and services.
i Financing

Private equity 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, promoting investment even in sectors that were previously exclusively reserved for the state, such as the oil sector. In less than a decade, private investments have multiplied every year. For the past two years, Mexico has been a leading market in Latin America for general partner investment. However, Mexico’s market is still below expectation, although capital funds continue to grow within the market. Regulatory reforms are expected to continue with the growth of private investment. Nevertheless, 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 due to the opportunities created by the opening of this sector. Even though oil prices have fallen, benefits from the energy reform of 2013 have emerged in Mexico. For the past two years, the energy sector has assumed an important role in the country due to the opening up for private investment. With the opening of the energy sector to foreign and private investment, 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 result of the opening of such 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, which 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 the fintech industry, Nexxus Capital has just announced its investment in Translatum Holding to develop a fintech platform and position itself as one of the leading companies in providing services to send money from the United States to Mexico and other Latin-American countries.

Several mezzanine funds were launched by the end of 2016: for example, Adobe Capital, after the success of its first mezzanine fund, launched a second one with the same objective of supporting the growth of social and environmental companies; and Vector Partners, a company related to Vector Casa de Bolsa, in alliance with, inter alia, the International Finance Corporation (World Bank Group), launched México Mezzanine Uno, a fund that will request less guarantees to give small and medium-sized companies a better chance of obtaining financing.

In addition, in the food industry, Glisco Partners invested in the Hunan Group, owner of 14 restaurants in Mexico City, to boost its growth and strengthen its financial position as well as its internal corporate governance.

iii Exits

In early 2017 we saw a fund-to-fund transfer: EMX Capital sold Arabela, SA de CV to Adas Capital. Arabela, a direct selling company for beauty and other women’s products, is a leader in the Mexican market.

In January 2017, Grupo IGS sold one of its portfolios including nine buildings, meaning that the group has disinvested a total of 40 per cent of its industrial and residential portfolio.
IV REGULATORY DEVELOPMENTS

Among the legal developments that have taken place due to the investing environment in Mexico, two developments in 2015 saw the legislation regarding the Real Estate Trust for the Energy Sector and Infrastructure (Fibra E) and investment project certificates (CerPIs). Fibra E vehicles are investment vehicles similar to Fibras, Mexican real estate trusts, which have been successful in recent years and which can increase the financing of projects in the energy sector.

In October 2016, the Fibra Vía (the new Fibra E), issued by Pinfra, concluded the first public offering in Mexico of 394.5 million energy investment trust and infrastructure certificates. The placement reached 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 placed in 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 and a first issue for 800 million pesos.

CerPIs and Fibra E have not yet been widely used, but are expected to be instruments that boost the capital of investments in Mexico. Still, we can expect that the legal aspect of private equity will continue evolving.

V OUTLOOK

Since 2009, private equity in Mexico has been a growing market. CKDs boosted transactions when pension funds began participating. Fundraising is now much easier, because funds are able to raise both national and international capital and because legislation is making the process more effective. Nonetheless, publicly traded companies are typically controlled outside the stock market (by a family or other closely held group), which substantially limits public-to-private equity deals. Mexican firms are very reluctant to give away control or even provide transparency as a condition to accept private equity. Many Mexican firms and their owners and managers lack experience in private equity transactions (it is not perceived as an integral part of a firm’s growth strategy, but as a way to lose control and direction of the firm), so deals in Mexico can sometimes move very slowly, which private equity firms may find frustrating given the fast-paced nature of their typical transactions.

Even with the ongoing culture of the family company, Mexico is gradually becoming a good country to invest in, with one of the most attractive prospects being the energy sector. Additionally, fintech and telecommunications appear to be sectors to follow closely for investment opportunities, which will be encouraged by regulatory policies.

Other regulatory reforms regarding competitive markets and anticorruption will undoubtedly be important steps for Mexico towards playing a significant role globally in terms of investment.
Chapter 17

NORWAY

Peter Hammerich and Markus Heistad

I OVERVIEW

i Deal activity

The Norwegian private equity sector is, much like the Norwegian economy, directly or indirectly exposed to the oil and gas extraction and related industries (products and services) through its investments. The Norwegian economy remained, in part due to the income derived from oil and gas extraction, largely unaffected by the consequences of the financial crisis of 2007–2008 and the subsequent sovereign debt issues in Europe. However, the substantial reduction in the price of oil starting 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) has made itself felt in the Norwegian ‘real’ economy, with severely reduced investment activity, lay-offs of personnel and debt restructuring in the oil-related sectors.

These developments in the Norwegian economy affect private equity investors, as they do other investors. The most direct consequence of the reduction in oil prices, has been that sellers have shown hesitant to sell based on the reduced oil prices. Correspondingly, buyers have been generally unwilling to buy based on the older higher prices. The perceptible reduction in deals towards the end of 2014 carried on into 2015 and 2016. How and to what extent the reduction in oil prices will affect the private equity sector in the longer term, remains to be seen. This will of course depend upon the future oil prices, other economic factors, and whether the oil price reduction will remain a long-term trend.

While funds advised by Norwegian managers invested a total of 6.5 billion kroner in 2014, the numbers for 2015 increased slightly to 8.9 billion kroner. There was one public-to-private deal in 2015 and none (of any significance) in 2016. There has been a substantial and lasting decline in the number of exits being made in the form of an IPO, mirroring the relative

1 Peter Hammerich is a partner and Markus Heistad is a senior lawyer at BA-HR DA.
2 Official Brent Oil Prices.
3 Activity report 2015, Norwegian venture capital and private equity association (NVCA).
4 Internal study, BA-HR DA.
5 Activity report 2015, Norwegian venture capital and private equity association (NVCA).
6 Activity report 2015, Norwegian venture capital and private equity association (NVCA), Internal study, BA-HR DA.
The decline of the Oslo Stock Exchange (also seen in regulated markets in other countries) as a source for risk capital. This trend may indicate that IPOs are not seen as a viable exit route, except in exceptional cases.

The fundraising level for 2015 was merely 889 million kroner, with no major fundraisings and none in the buyout segment. Although no official statistics have been released yet, this number will have been largely surpassed in 2016. In 2016, Norvestor Equity closed its latest fund, Norvestor VII, at 4.9 billion kroner, OMP Capital AS, a portfolio company of HitecVision V LP, successfully closed their OMP Asset Yield Fund at US$381 million in commitments and FSN Capital closed its fifth fund, a Nordic mid-market buyout fund at 9.62 billion Swedish kronor.

As at the end of 2016, a total of 105 Norwegian alternative investment fund managers were registered or regulated by the Financial Supervisory Authority of Norway, of which approximately half are private equity managers. The exact number of funds in existence is unclear, as many private equity funds will be covered by the grandfathering rules under the AIF Act, implementing the AIFM Directive. Five foreign private equity managers had a fixed place of business in Norway.

The Norwegian private equity scene may be divided in five main categories. The first category consists of relatively large generalist private equity investors, represented by FSN Capital, Herkules Private Equity and Norvestor Equity. The second category consists of sector-specialist investors, represented by HitecVision and Energy Ventures, both focusing on technology and assets connected to the exploration of oil and gas. Thirdly, there are a number of managers in the venture and seed capital segments, most prominently Northzone ventures, which has made investments in a number of technology companies, such as Spotify and Klarna.

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). Occasionally, international private equity funds are active in the Norwegian market, as exemplified by the acquisition of Evry, a leading Norwegian IT company by Apax, and TDR Capital's acquisition of Hurtigruten ASA (a Norwegian cruise liner). These transactions took place during 2014 and the companies delisted in 2015.

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, as well as completing co-investments with private equity funds, and 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 2015, the investment portfolio of Investinor AS amounted to 1.77 billion kroner. Investinor has financial assets and a commitment from the government amounting to 4 billion kroner.7 The fund has sustained losses on its portfolio during the past few years.

There were two newcomers to fund sponsors in Norway in 2016; Longship AS, which advises a Guernsey established fund targeting medium-sized growth companies in Norway, and Serendipity Partners AS, which manages Nordic and Europe Health Invest, a fund focusing on investments within healthcare.

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7 Source: Investinor AS, Q3 2016 report.
The EU Alternative Investment Fund Managers Directive (AIFMD) was implemented in Norway in 2014 through the AIF Act, and transitional provisions expired on 31 December 2014. So far, the implementation has not produced any substantial changes in the private equity landscape. Some sponsors have, however, chosen to offshore to countries outside the EEA, while others, such as Norvestor Equity and HitecVision, have chosen to bolster their onshore operations through authorised management companies.

**ii Operation of the market**

*Management incentive schemes*

A key element of private equity investing is incentive schemes aimed at key personnel both at the fund (sponsor) and portfolio company levels. 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 the participants and choice of investment model. Subject to the AIF Act (see Section V, *infra*), authorised fund managers are subject to remuneration rules that may affect incentive schemes that are not investment-based (carried interest).

In 2012, Norwegian courts decided in the first case to concern taxation of carried interest distribution (see Section IV.ii, *infra*).

At the portfolio level, it is common practice for private equity funds to require that leading employees of a portfolio company shall own shares in such company by reinvesting alongside the fund in connection with a fund’s acquisition of the company. Incentive schemes aimed at such persons have evolved over the past 10 years, migrating from option-based and bonus-based models to almost exclusively investment-based models.

In some cases, leading employees invest on the same terms and with the same risk on their investment as the fund. 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 imply that the fund shall be entitled to receive the entire amount it has invested, plus a predefined return on such 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 of time,
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 undertake restrictive covenants such as non-compete and non-solicitation, 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 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 no longer commonplace, meaning that most exits take the form of a secondary sale or trade sale to an industrial actor.

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 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.

## II LEGAL FRAMEWORK

### i Acquisition of control and minority interests

The investment objective of private equity funds is generally to achieve superior returns through control in its portfolio companies. In this section, we provide a brief description of the legal framework for a control investment in Norwegian public and private limited companies. Our discussion is limited to equity investments (we do not discuss asset transactions).

Listed companies are a subset of public companies. The regulatory regime applicable to takeover offers on shares differs significantly, depending on whether the target company is listed on a regulated market or not. Acquisition of controlling stakes in listed companies triggers particular requirements.

Norway has implemented the EU Takeover Directive\(^8\) 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

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\(^8\) Directive 2004/25/EC.
Germany offers. A voluntary offer, if accepted by the recipients of the offer, triggers a mandatory offer obligation for the buyer. A mandatory offer for the remaining shares in the target is triggered if the buyer (either through a voluntary offer or otherwise) becomes owner of more than one-third of the voting rights in the target (with repeat triggers at 40 and 50 per cent). Further, Norway has implemented the EU Transparency Directive through rules in the Norwegian Securities Trading Act, requiring major shareholding notifications. Norway has not implemented the revised EU Transparency Directive (as amended through Directive 2013/50/EU) yet. This is expected in 2017.

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.

However, 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 (dividend), capital reduction, share redemption and acquisition of own shares for a period of 24 months.

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 1,000 million kroner or more, and at least two of the undertakings concerned each have 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. Such aspects must be assessed on a case-by-case basis. In Norway, this applies within, for example, the financial sector, fisheries, oil extraction and production 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

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9 Directive 2004/109/EC.
10 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.
considerations relevant to the choice of structuring of an investment in order 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.

ii Fiduciary duties and liabilities

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’.11

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 provide for greater flexibility concerning financial assistance for limited companies. This would require amending the relevant company acts, which have yet to be formally proposed. It is uncertain when such 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.

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). Depending on the development of the relevant portfolio company or the prevailing market conditions, an exit may not be made as initially planned; 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. Current Norwegian tax legislation will normally imply that asset transactions are less favourable than equity transactions.

11 The Private Limited Company Act and Public Limited Company Act, Sections 6 to 28.
Rights of stakeholders

As a general rule, Norwegian law does not confer any legal rights to 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.

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 damages 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 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.

III YEAR IN REVIEW

i Recent deal activity

The total amount invested increased in 2015, compared to the year before, but the number of deals was lower, meaning that the size of deals has generally increased. There was a marked increase in buyout investments, particularly in the form of follow-up investments.12

There were generally few large transactions made by Norwegian private equity sponsors, but foreign funds have made several investments in Norway. Notable examples are UK-based HgCapital's acquisition of Visma BPO from Visma AS in a deal valued at approximately 500 million kroner.13 Norwegian generalist manager Norvestor Equity sold its stake in Phonero AS to the Swedish telecoms operator Telia valuing the company at 2.3 billion kroner on a cash and debt-free basis.

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. Further, 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, that only banks and regulated financing undertakings may carry out. This may change upon transposition of the EU EuVECA and ELTIF-regulations, that will allow such funds to provide loans (within certain limitations).

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. This

12 Activity report 2015, Norwegian venture capital and private equity association (NVCA).
13 Internal study, BA-HR DA.
may, however, change depending on how Norwegian banks will be affected by the ongoing downturn in the oil and oil services markets and exposures in those sectors. Norway has implemented the substantive rules of the EU CRD IV capital requirements, based on Basel III.

Terms for bank financing are highly standardised, but the content of covenants will differ from case to case based on, *inter alia*, the financial position and business of the target company.

### iii Key terms of recent control transactions

The terms of control transactions made by Norwegian private equity funds will as a rule be confidential. The disclosure rules under the AIF Act with respect to acquisition of control do not require the disclosure of such information, but the timing of such acquisitions may become public knowledge faster than before. 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, 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 in order to achieve an appropriate exit.

### iv Exits

The downward trend in investment activity also reflects upon the exit activity, with fewer exits than the year before. The lower exit activity primarily affects oil and gas-related sectors.

As mentioned above, Norvestor Equity exited its investment in Phonero AS to Swedish telecoms operator Telia.

### IV REGULATORY DEVELOPMENTS

#### i Regulatory changes

The AIF Act, implementing the EU AIFM Directive, came into force on 1 July 2014 with grandfathering rules expiring on 31 December 2014. As a consequence, Norwegian private equity managers have now been subject to regulation for two full years. The AIF Act requires Norwegian private equity managers to register or to be authorised by the Norwegian regulator. The majority of Norwegian private equity managers have assets under management below the threshold values requiring authorisation (€100 or €500 million, depending on the fund terms). More will likely be affected by the authorisation requirement following cross-border management or marketing, or the fact that an authorisation is required to market units in funds to non-professional investors in Norway.

Although the AIF Act is aimed at managers only, certain provisions have consequences at the fund level. This concerns primarily the requirement to appoint a depositary, but also reporting and disclosure requirements that require adaptations at the fund level. Private equity fund managers are now subject to a particular reporting requirement in the case of acquisitions of portfolio companies and regulations aimed at preventing ‘asset stripping’ of portfolio companies not applicable to other investors (see Section II.i, *supra*).
The AIF Act regulates marketing both to professional and non-professional investors, and these rules must be considered before fundraising in Norway. Prior to the entry into effect of the AIF Act, marketing of private equity funds was not subject to any specific rules. Private equity funds established within the EU or EEA and managed by an authorised AIFM may now be marketed to professional investors in Norway on the basis of the AIFMD passport regime. Marketing funds established outside the EU or EEA (regardless of the domicile of the manager) is legal only with a prior marketing authorisation from the Norwegian regulator. The latter also apply to marketing to non-professional investors, which only may be done by managers established within the EU or EEA. Marketing to non-professional investors is subject to a specific authorisation requirement. Notably, the manager must be authorised under legislation implementing the AIFMD (thus excluding non-EEA managers), the manager must be a member of a complaints handling scheme, produce a key information document and comply with the code of conduct rules under the Norwegian Securities Trading Act (requiring that the manager assesses whether an investment is suitable for the prospective investor).

Private equity funds, or other alternative investment funds established in Norway that are not defined as ‘securities funds’ subject to the Norwegian Investment Fund Act, are not regulated. As a consequence, Norwegian alternative investment funds will, at the fund level, be subject to Norwegian company law only (outside securities laws).

Norway is not a member of the EU system of financial supervision. Norway has entered into an agreement with the EU on (partial) integration into the system of financial supervision which was ratified in 2016, paving the way for a relatively high number of EU legislative acts being implemented in short order (CRD IV, Solvency II, AIFMD, MiFID II, UCITS V, EMIR, the short-selling regulation, etc.). Norway will also implement the new EU regulations concerning venture funds and social entrepreneurship funds, as well as the regulation on long-term investment funds. These regulations will regulate funds aimed at specific markets, and give Norwegian managers of such funds easier market access allowing for more efficient fundraisings. The FSAN has stated that implementation of the ‘backlog’ of legislative acts is likely to take between 18 to 24 months.

Norway is a member of the OECD Multilateral Competent Authority Agreement concerning automatic exchange of financial information for tax purposes. National legislation implementing the Common Reporting Standard entered into force on 1 January 2016, requiring Norwegian asset managers to collect and verify information on clients’ and investors’ home state for tax purposes and to report to Norwegian tax authorities. For private equity sponsors, the rules have proved somewhat complex with respect to portfolio holding companies and co-investment vehicles, and whether they constitute reporting ‘investment entities’ or not.

**Local tax treatment of 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.

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 arm’s length principles). 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 the market developments.

The judgment by the Supreme Court is relevant also for other management companies and their partners. After the win in the court of appeal, the tax authorities announced that they would file claims against 40 partners connected to six other funds. After the Supreme Court judgment, it is expected that these cases will be dropped, at least with regard to the reclassification of carried interest to salary. At the same time, it is still an open question whether carried interest shall be considered as business income or capital income. This question must be assessed on a case-by-case basis, where the economic risk taken will be of importance. The judgment of the Supreme Court gives no guidance in this regard. Hence, the question of tax treatment of carried interest will remain a point of interest.

iii Finance tax

As of the income year of 2017, a specific ‘finance tax’ will apply 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 (as compared to 24 per cent, which is the general tax rate on business income). The tax comes as a result of an ongoing debate on introduction of value added tax in the finance sector. In 2016 the government decided to abandon this (for now) and instead introduce a tax on actors in the finance sector. It has been stated that the structure of the tax will be reviewed, which may lead to adjustments in the future. The tax will generally encourage outsourcing of functions in order to reduce the tax base.

V OUTLOOK

The immediate future of the Norwegian private equity industry will be dominated by any long-term effects of the financial crisis and reductions in oil prices, as well as regulatory changes initiated in the EU.

The financial crisis led to an immediate dearth of bank financing for private equity deals (as well as industry deals). As a consequence of the crisis and the strengthened (and still changing) banking regulation in the aftermath of the crisis, the availability of banking finance
is relatively lower than it was pre-crisis. This has led to changes to the financing structures of both the acquisition and disposal of portfolio companies, with increased mezzanine financing, which historically has had only a limited role in Norwegian deals (this is also due to the current regulation of banking services, which effectively prohibits mezzanine funds access to the Norwegian credit market).

Funds exposed to the energy sector may see lower returns on investments due to the decrease in oil prices. This is likely to affect both investments and exits in 2017, as managers will probably delay exits. Norway is a Member State of the EEA. As such, it is required to implement the majority of EU legislation pertaining to the free movement of persons, goods, services and capital. As a consequence of the expected integration into the EU system of financial supervision, Norwegian fund managers should see their market access (in Europe) increase in 2017.

More in the long term, Norwegian fund sponsors will have to get to terms with the effects of the rapidly changing regulatory regime in the financial sector. The Solvency II directive has affected EU insurance companies requirements to investing in private equity. Further, Norwegian authorities are proposing changes to the capital requirements for pension funds, which should have a natural bias towards the long-term nature of private equity investments.
Chapter 18

POLAND

Marcin Olechowski, Borys D Sawicki and Jan Pierzgalski

I OVERVIEW

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 2015, 102 private equity investments with an aggregate value of €803 million were made into companies domiciled in Poland. The number of investments was high (compared with, for example, 58 investments in 2007, 71 in 2008, 74 in 2012, 89 in 2013 and 78 in 2014). Their total value was the highest in the past nine years – in previous record year, 2011, private equity investors invested €678.4 million in Polish portfolio companies, €380 million in 2013 and €251 million in 2014. There were 20 buyouts in 2015 with an aggregate value of over €700 million. The total of 19 new growth investments in 2015 had a value of €79.3 million.

Poland is the biggest private equity market among CEE countries, hosting 53 per cent of investments in the region. By number of investments, the most prominent investments were in venture capital, making up 61 per cent of the total. By value, the most important transactions were growth capital and buyout investments, representing 98 per cent of the total value. Venture capital investments were primarily focused on start-ups: in terms of volume, approximately 45 per cent of venture capital transactions were made into start-ups, and in terms of value, approximately 40 to 50 per cent.

2015 was another year of exits. A total of 44 divestments was valued in the aggregate at €800 million. This was the highest value of divestments in the past nine years. By comparison, there were 24 divestments in 2012 (from investments valued in total at €184.3 million), 21 in 2012 (€52.8 million), 36 in 2013 (€284.7 million) and 35 in 2014 (€530 million).

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1 Marcin Olechowski is a partner, Borys D Sawicki is a senior counsel and Jan Pierzgalski is an associate at Sołtysiński Kawecki & Slezak.
2 2016 figures are not yet available.
5 Rynek private equity w Polsce 2016, KPMG.
6 See footnote 3.
The most common exit route in Poland is a trade sale; in 2015, half of exits were performed by sale to an industry investor. In terms of value of divestments, the leading exit route was through a trade sale with a value of over €409 million, contributing to as much as 54 per cent of the total value of exits (in 22 transactions). In 2015 there were seven exits via the public market: two IPOs and five sales of quoted equity with an aggregate value of over €206 million. Management buyouts were exit routes in approximately 11.4 per cent of all divestments; however, these contributed only 1.4 per cent of income from all of the exits. A sale to another private equity house was an exit route in three instances (6.8 per cent), which amounted to 15.1 per cent of the total value of divestments. There were no divestments by write-offs or repayments of silent partnerships.7

The most popular sectors for private equity investments by number of transactions were computers and consumer electronics, business services and IT, media and communications. By value, the most preferred sectors were energy, and retailing and consumer goods.8

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 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.9 Investment funds actively monitor the market and seek potential investment opportunities (38 per cent of analysed investment projects were found by funds’ investment teams).10 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).11

7 See footnote 4.
8 See footnote 5.
9 Ibid.
10 Ibid.
11 Rynek Private Equity w Polsce: fakty a opinie, 2014, KPMG Poland.
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 due to tax reasons). A change in the form of running a business and the enterprise’s contribution into the company requires diligent separation of business assets from personal property, and identification of debts connected with the business.

The Polish M&A market is relatively professional, and local sale processes are largely aligned with general European practice. The majority of sellers (however, 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 for the Polish market) tend to be time-consuming, especially due to the owners’ overestimation of their enterprise’s value.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Types of companies

The vast majority of investors’ targets in Poland are companies governed by the Polish Commercial Companies Code (CCC). Thus, the CCC creates the basic legal frameworks regulating control over a target and the rights of a minority investor.

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 of the shareholders)
appoints the supervisory board members (while the supervisory board nominates the management board), has the power to dismiss members of the supervisory board and management board, and has the power to adopt critical resolutions for the company. Obtaining basic control over the company requires the acquisition of more than a 50 per cent stake; however, some important resolutions require a higher majority.

Reaching a 50 per cent plus one share shareholding allows the shareholder to appoint the majority of the supervisory board, and indirectly gives the shareholder control over the personal policy of the company. The CCC prohibits shareholders from giving management or supervisory board members binding instructions; however, due to the fact that the general assembly has the power to dismiss the company’s managers, shareholders have in practice indirect influence over the policy of the supervisory and management boards.

Although the management board runs the daily operation of a joint-stock company (shareholders are not entitled to act on behalf of the company), undertaking the majority of fundamental corporate actions requires a resolution of the general assembly. A general assembly resolution is required to, inter alia:

a. amend the statutes;
b. appoint supervisory board members;
c. approve financial statements and the management board’s annual reports;
d. dispose, lease or encumber a company’s enterprise or its organised part;
e. acquire or dispose of real estate (unless the statutes provide otherwise);
f. issue bonds or subscriptions warrants;
g. increase share capital and issue new shares;
h. allocate profits;
i. exclude a shareholders’ pre-emptive rights (the required majority of votes is four-fifths);
j. dissolve the company;
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.
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 clause of ‘good practices’ allows the majority shareholder’s actions to be opposed in a wide range of circumstances if the company’s or other shareholders’ interests are harmed. Although there are no specific provisions of law governing the matter, legal doctrine and jurisprudence have developed the concept of a duty of loyalty, which shareholders (especially a majority shareholder) owe to the company and other shareholders.

Due to the nature of commercial companies, the liabilities of a shareholder towards a limited liability company or joint-stock company are, generally, limited to the proper fulfilment of an obligation to make a contribution to the company (in exchange for shares). In the case of an acquisition of shares, the acquirer is jointly and severally liable for the contribution with the seller. A shareholder is also responsible towards the company or other shareholders in accordance with the general principles of civil law (i.e., for damages caused by illegal actions).

Company officers (members of the management and supervisory boards, liquidators) are personally liable for the damage caused to the company by their actions or omissions contrary to the law or the statutes, unless they were not at fault. Company officers should perform their duties with higher standards of care connected with the professional nature of their positions; they should act diligently, reasonably, cautiously and with foresight, and anticipating the results of undertaken actions. They are also obliged to act in the best interests of the company (which is independent from the individual interests of shareholders) and treat shareholders equally. Management board members cannot conduct a competing business activity without the company’s consent and are obliged to refrain from performing duties in the case of a conflict of interest. Shareholders, the general assembly and the supervisory board are not entitled to give the management board or its members binding instructions with respect to the management of the company’s affairs.

Management board members in limited liability 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.
iii Regulations applying to foreign investors

Poland, as a Member State of the European Union, forms part of the European Union’s internal market and aims to guarantee, within the framework of applicable regulations, the EU’s ‘four freedoms’ (i.e., the free movement of goods, capital, services and people).

While the obvious beneficiaries of Poland’s membership in the EU are entities from the remaining 27 EU Member States, Poland sets out very few barriers for investors from non-EU countries, as 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 of Poland, or a company domiciled in Poland but controlled by a foreign entity) acquires real property or obtains control over a company holding real property, a prior approval of the Ministry of Internal Affairs is required (under pain of nullity).

The AAREF, subject to some minor exceptions, does not apply to foreigners from the 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.

In 2015, a new Act on Control over Certain Investments (ACCI) entered into force. The purpose of introducing the ACCI was to give the government a tool with which 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 Ministry of the Treasury, 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 2017, only seven entities (mostly leading Polish companies in the energy sector) are subject to ACCI regulations.

iv Tax matters

Poland conforms to current global trends aimed at closing the remaining loopholes in the tax system through various regulations, such as the general tax anti-abuse rule (GAAR), new transfer pricing documentation requirements, taxation of closed-end investment funds (CIFs) and the ‘small’ anti-abuse clause applicable to the exchange of shares.

Poland participates in the BEPS project 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 is 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 will allow the authorities
to ignore artificial legal arrangements, which means that 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.

So far, the most effective structures for tax optimisation of business activity carried out in Poland have been based on Polish CIFs. However, from January 2017, this is mostly not possible. The government has decided to exclude the income tax exemption for CIFs (the Polish FIZ and similar EU-based investment funds) with respect to income generated through tax-transparent partnerships, disposal of interest or shares in such partnerships, and other income related to participation in such partnerships (including passive income). This means that such income is now subject to 19 per cent income tax.

A full tax exemption will be still available to Polish open-ended investment funds and special open-ended investment funds (SFIOs) unless a SFIO applies investment principles and limitations relevant for CIFs. Comparable EU-based investment funds fulfilling certain conditions will also retain the income-tax exemption.

The main purpose of the taxation of CIFs is to eliminate those structures in which Polish and foreign CIFs participate with the use of fiscally transparent entities, utilised for tax the optimisation of taxpayers’ profits generated from the current business activity. Such an activity is against the primary purpose of establishing the tax exemption of CIFs, that is, exemption from the taxation of the taxpayers’ investment activity conducted through such CIF.

Various tax optimisation solutions regarding contributions of assets to companies, with a portion of the contribution allocated to the share premium, are also now ineffective. 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 justified economic reasons warranting preferential taxation of mergers and demergers of companies has also been introduced. This ‘small’ anti-abuse rule has been also expanded to the exchange of shares (and previously in 2016, to dividends). These exchanges will no be longer tax neutral if there are no justified 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 for transfer pricing documentation, more comprehensive information on related party transactions should be disclosed to the tax authorities. Under these new provisions, taxpayers are obliged to prepare more extensive transfer pricing documentation (in particular, local files are expanded). In most cases, benchmarking studies would be necessary.

Poland has commenced its battle to prevent tax avoidance and tax evasion through introducing numerous regulations designed to combat these negative phenomena. It is no exaggeration to state that Poland is becoming a less tax-friendly country, which consciously limits the possibility of tax optimisation.
III YEAR IN REVIEW

i Recent deal activity
Although no statistical data for 2016 are available yet, market participants and observers indicate that 2016 has continued to witness the market dynamics observed in 2014. The priority for CEE region investors is to make new investments. In September 2016, 70 per cent of respondents intended to focus on such new investments, while only 23 per cent claimed that they will focus on portfolio management. Investors expected the average size of transactions to remain the same (67 per cent of respondents), while 20 per cent claimed that it will increase. Overall, 47 per cent of investors expected to sell more than buy. Investors also expect that the biggest competition between acquirers will be among market leaders. Middle-sized growing companies remain popular, but are seen as being less competitive.

Fundraising now takes longer; the fundraising phase currently can take up to 18 months, compared with just a few months some years ago.

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 €200 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 polish market is Polski Fundusz Rozwoju (PFR), established by the Ministry of Treasury with the State Treasury and Bank Gospodarstwa Krajowego as stockholders. PFR holds the means of approximately €504 million, provided for five funds of funds. One of them has already issued a notice of call for proposals. Open pensions funds are, in turn, restricted from investing on the private equity market.

ii Financing
Due to the lack of ‘mega-deals’ on the Polish private equity market over the past few years, acquisition financing structures have remained rather simple. The typical structure of financing consists of an investor’s equity, banking loans (senior debt in the case of other financing) or other sources of financing (e.g., bonds). According to market surveys, 71 per cent of private equity investors consider that debt financing is easily available and does not pose an execution risk. A quarter of respondents claimed that debt financing is difficult to obtain, although promising prospects can be sure to succeed in that 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.

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14 CE Private Equity Confidence Survey, May 2016, Deloitte Poland.
15 Ibid.
16 Ibid.
17 See footnote 13.
18 KPMG Poland; see footnote 5.
19 Time for another look – Central & Eastern Europe Private Equity, 2013, PSIK.
Poland

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 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 of the shareholders will include the right to appoint some of the management or supervisory boards members (or both) to monitor the company’s regular business activity; and the establishment of a blocking minority to protect the shareholders from a loss of investment value (e.g., in the case of the adoption of resolutions approving the disposal of key assets) and from the dilution of their corporate

20 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.
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 between 15 and 25 per cent of the purchase price (with, however, 100 per cent of the purchase price as the cap for liability on title). Representations and warranties insurance is 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 such given company, the structure of its assets, and the value or area of the given agricultural land are irrelevant for the application of the priority right. On the other hand, there is no register of agricultural lands in Poland, and in certain cases it is not clear whether such land is in fact agricultural. As a result, in the case of any share deal, 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.

iv Exits

In the opinion of private equity investors, the most likely type of exit from an investment is a trade sale to a European strategic investor outside the CEE.21 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.

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

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21 KPMG Poland; see footnote 5.
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.

Moreover, since 4 June 2016, when the 2016 Act Amending the Act on Investment Funds and Certain Other Acts entered into force, a legal framework has been established for a new category of investment vehicles – namely alternative investment companies (ASIs) – that 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 concentration. Until the UOKiK issues a decision allowing the transaction (or the lapse of the statutory deadlines for the UOKiK to issue the clearance, which are one or four months depending on the complexity of the transaction), the acquirer should refrain from closing the deal. Antitrust issues are especially relevant in the case of a trade sale exit.

V OUTLOOK

We believe that, overall, the Polish private equity market has significant potential for further growth.

Poland is typically the largest CEE private equity market – in 2015, the share of Polish exits of the total amount of exits in the region amounted to as much as 65 per cent, while the share of Polish investments amounted to 54 per cent by value. Poland still hosts the highest number of companies invested. At the same time, the value of private equity investments in Poland amounted to 0.21 per cent of the country’s GDP, which is still less than the European average of 0.30 per cent. These two factors, when combined, suggest that the already large market should continue to expand. A high average rate of return on investment (2.78 over the past decade) adds to the positive picture of Poland as the place to invest.

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23 See footnote 3.
24 Ibid.
KPMG survey\textsuperscript{25} respondents have claimed that in the past two years, the Polish market has offered huge opportunities in the scope of attractive investment targets. Some respondents stated that the number of available transactions in the small companies sector has increased. It was also said that the quality of portfolios is getting better. According to some private equity investors, companies’ knowledge about private equity functioning is continuing to grow. Owners tend to understand the benefits of such cooperation, as well as investors’ demands and expectations. According to the respondents’ opinion, in 2015 the average valuation of companies in Poland was higher than in Western European countries. Taking everything into consideration it seems that Poland is a good place to invest.

\textsuperscript{25} Ibid.
Chapter 19

PORTUGAL

Francisco Brito e Abreu, Marta Pontes, Joana Torres Ereio, José Maria Rodrigues and Gerard Everaert

I OVERVIEW

i Deal activity

The most recent reports on private equity activity, both from industry sources and official Portuguese sources, contain information up to the end of 2015.

According to Invest Europe, private equity investment in Portuguese companies amounted to approximately €152.1 million in 2015. This figure is the lowest ever since 2007, when investment totalled €213 million. It is also a noticeable decrease when compared to 2013 and 2014, when total investment amounted to approximately €339 and €265 million, respectively.

Buyout transactions were the predominant type of transaction in 2015, totalling approximately €49.5 million (32.5 per cent of the total). This amount was invested in 27 companies. Venture capital investment in start-ups was the second most relevant type of deal in terms of value, representing 28.3 per cent of all investments or, more specifically, €43.1 million, invested in 75 companies. ‘Growth capital’ deals also made up a significant percentage of investments in 2015, totalling €30.7 million invested in 24 companies and amounting to 20.2 per cent of all investments in terms of value. In all of the above, the figures seem to indicate that deals are, in most cases, on a small or a very small scale.

It is worth noting that 2015 was the only year apart from 2007 in which venture capital investments (including seed stage investments, investment in start-ups and later stage ventures) exceeded buyouts.

The statistics reveal that only €16 million of the total investments came from foreign countries; thus, local sponsors were responsible for almost 90 per cent of all investments.

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1 Francisco Brito e Abreu and Marta Pontes are partners, Joana Torres Ereio is a senior associate and José Maria Rodrigues and Gerard Everaert are associates at Uría Menéndez – Proença de Carvalho.
2 All the statistics in this sub-section were obtained from Invest Europe’s 2015 Yearbook (www.investeurope.eu/research/activity-data/annual-activity-statistics). As such, they are limited to the sphere of the Yearbook. The methodology used to define such sphere is described at the above link.
As regards divestments, and excluding the data on ‘divestments by write-off’, ‘repayments of silent partnerships’ and ‘repayments of principal loans’, 37 transactions took place in 2015 with a total value of approximately €171 million. This number largely exceeds the total divestments in 2014 and 2013, which amounted, respectively, to approximately €60.4 million and €71.3 million. It also exceeds the total divestments in 2007, which totalled approximately €82.9 million. Private transactions accounted for all divestment transactions: no divestment through public offering has been recorded at any time in Portugal since 2007. The predominant divestment strategies have been sales to management (totalling 18 deals) and sales to financial institutions (totalling 13 deals). Only four trade sales took place in 2015 (although it should be taken into account that trade sale is defined by Invest Europe as ‘the sale of company shares to industrial investors’).

Some of the most active local sponsors are Explorer Investments, Capital Criativo, Inter Risco, ECS, Caixa Capital, Portugal Ventures and Oxy Capital. As regards foreign sponsors, many have either invested or been mentioned in public sources as having an interest in investing in the Portuguese market in the past, such as Apollo Global Management, The Carlyle Group, Lone Star Funds, Apax Partners, Cerberus Capital Management and Blackstone.

ii Operation of the market

Sale processes

Negotiated private transactions are the norm in Portugal for private equity.

Within private transactions, both auction processes and proprietary (bilateral) negotiated deals are common. However, auctions are only likely to be used in more valuable transactions due to their higher complexity and increased costs.

It is common for proprietary transactions to begin with the negotiation of non-disclosure and exclusivity agreements. These documents may be followed or accompanied by preliminary documents such as transaction term sheets, memoranda of understanding, letters of intent or non-binding offers that may include an indicative price, provisions on how the price is to be paid and other essential terms of understanding between the parties to proceed with the transaction. Break-up fees may or may not be included, depending more on the parties’ commercial concerns than on any other factor. Due diligence is often performed after signing the aforementioned documents, but can include also ‘high-level’ preliminary due diligence carried out beforehand, covering the disclosure of information on selected aspects, so as to allow the purchaser to take an informed decision on whether to continue with the process. After satisfactory due diligence, the normal course of action is for a purchase agreement,

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5 Defined as ‘the write-down of a portfolio company’s value to zero or a symbolic amount’.
6 A ‘silent partnership’ is defined by Invest Europe as follows: ‘A silent partnership belongs to the so-called mezzanine financing instruments. It is similar to a long-term bank loan, but, in contrast to a loan, a silent partnership is subject to a subordination clause, so that, in the event of insolvency, all other creditors are paid preferentially to the silent partner. The company has to repay the partnership and has to pay interest and possibly profit-related compensation.’
7 Defined by Invest Europe as follows: ‘If the private equity firm provided loans or purchased preference shares in the company at the time of the investment, then their repayment according to the amortisation schedule represents a decrease of the financial claim of the firm into the company, and hence a divestment.’
together with any other transaction documents such as shareholders’ agreements, to be negotiated. Depending on the particular features of each transaction and the complexity of the deal, the entire process usually takes several months to be completed.

Auctions usually involve a financial adviser working together with the seller, and tend to begin with a process letter from the seller to several potential purchasers setting out the terms under which each addressee is invited to present an offer to purchase the target. The letters are usually accompanied by information memoranda or similar ‘pitch book’ documents prepared by financial advisers to the seller, and provide information on key commercial, financial and any other fundamentals of the target. The process usually has more than one stage. In a first stage, prospective purchasers generally submit non-binding offers setting out an indicative price for purchasing the target. A shorter list of prospective purchasers is then invited to advance to the next stage, in which access to due diligence information is provided. After performing due diligence, potential purchasers submit a binding offer. Frequently, as part of their binding offer, purchasers are required to also submit a mark-up of a previously provided draft shares purchase agreement and other essential deal documentation. Once the seller has elected a bidder to proceed with the transaction, subsequent negotiation of the transaction agreements takes place. It is normal for the entire process to take six months or longer.

**Management incentive arrangements**

The structure of management incentive packages is usually driven not only by commercial but also by tax and employment law concerns.

Incentive plans that are purely linked to management salaries (i.e., payment of cash bonuses for reaching objectives) are sometimes used. However, this type of incentive can be inefficient from a tax point of view as bonuses paid to directors may be subject to an autonomous corporate income tax charge if certain conditions are not met. Normally, this type of incentive is combined with others, such as those described below.

One common form of incentive is allowing management to acquire equity in the target or in the acquisition vehicle at a valuation that represents a discount in relation to the valuation implicit in the total investment made by the fund (‘sweet equity’). One way of implementing this type of scheme is for the management team to acquire shares at par value, with the full amount invested being allocated to share capital and with management receiving as many ordinary shares as correspond to such investment; the fund can then allocate part of its investment to share capital and, in order not to dilute the management beyond the commercially agreed levels, allocate the remainder to shareholder loans, share premiums, ancillary capital contributions, preferred non-voting shares or other forms of non-dilutive contributions (it should be noted that certain mandatory rules under the Portuguese Companies Code apply to preferred shares, which can constrain the parties’ freedom to structure the package as intended; the same applies to share premiums, which cannot be directly distributed to shareholders and may only be used, pursuant to Portuguese law, for specific purposes; for these reasons, these two forms of non-dilutive contributions may be less desirable). This type of incentive is usually accompanied by lockup periods, tag-along and drag-along clauses, and ‘good leaver’ or ‘bad leaver’ provisions. The ultimate objective is to allow management to cash-out together with the fund upon divestment, which, from a tax point of view, can be more efficient than purely salary-linked compensation, as capital gains are, as general rule, taxed at a maximum rate of 28 per cent (except if the divestment
refers to a company resident in a listed tax haven, in which case a rate of 35 per cent applies) instead of the higher general progressive personal income tax rates applicable to employment or director remuneration.

Further types of incentive that are usually combined with the foregoing are ‘ratchet’ provisions consisting, essentially, of mechanisms whereby the fund commits to share with management part of its capital gains obtained upon divestment. The sharing of gains is made conditional upon the fund having obtained a minimum internal rate of return on its investment and, possibly, on the price at divestment being, at least, an agreed multiple of the initial investment made by the fund. This type of mechanism can have several tranches: for example, the fund may agree to share with management 10 per cent of all capital gains in the part of such gains amounting to a multiple of twice the initial investment 20 per cent of all gains in the part amounting to between twice and four times the fund’s investment, and an even higher percentage for the part of realised gains that exceeds a multiple of four times the initial investment. Whenever the fund’s interest has been acquired from management, the parties may agree to treat the shared ‘ratchet’ amount as an additional component of the purchase price initially paid by the fund to acquire such interest, so that the shared amount is subject to the improved tax treatment referred above regarding capital gains.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Prior authorisation requirements

As a general rule, the acquisition of equity stakes (whether control or minority stakes) in Portuguese companies by private equity funds or any other type of investor is not subject to any sort of administrative authorisation granted by any government agency or regulator. Particularly, investment by foreign entities, including non-EU investors, is not subject to any foreign investment prior authorisation. Foreign investors are not required to have a local partner when investing in Portugal, and there are essentially no limitations on the distribution of profits or dividends to shareholders located abroad. Likewise, as a general rule, no specific notification or registration is required for foreign individuals or entities that invest in Portugal. There are, however, exceptions to these general principles, one relevant example being, notably, the acquisition of relevant interests in entities in regulated sectors (such as credit institutions or insurance companies, which, regardless of the nationality of the prospective acquirer, require prior communication to, and no opposition from, the respective regulators).

Antitrust clearance from the Portuguese Competition Authority or from the European Commission may be required if the transaction is to meet or exceed concentration thresholds established by Portuguese or European law.

Control issues

Pursuant to the Companies Code, a company (regardless of where it is domiciled) that acquires (directly or through entities or individuals acting in concert with it) an interest of at least 10 per cent in the share capital of a Portuguese company must communicate this circumstance to the target in writing, as well as communicate to it in writing all further acquisitions or disposals of shares in the same, provided that the interest does not fall below such threshold of 10 per cent.
Whenever a Portuguese company acquires (directly or through entities or individuals acting in concert with it) an interest of 100 per cent in the share capital of another Portuguese company, the directors of the acquiring company must call a general shareholders’ meeting within six months of the acquisition of the 100 per cent interest so that the shareholders can decide whether to dissolve the acquired company, transfer an interest in the acquired company or keep the situation as it is.

Pending the adoption of any resolution, or if the shareholders of the acquiring company decide to keep the situation as it is, the acquiring company and the target will be considered to be in a ‘group’ relationship, which has consequences under the Companies Code. The ‘group’ relationship will be deemed terminated if either of the companies ceases to have a registered office in Portugal, the target is dissolved or more than 10 per cent of the share capital of the target ceases to be held by the acquirer.

Also pursuant to the Companies Code, a company that acquires, directly or together with individuals or entities acting in concert with it, at least 90 per cent of the share capital of a Portuguese entity is entitled to ‘squeeze out’ the remaining shareholders by purchasing their holdings, subject to conditions (particularly, the consideration must be deemed appropriate by an independent chartered auditor and must be in cash or in shares or bonds issued by the acquirer; furthermore, the consideration must be deposited in advance for the benefit of the minority shareholders). Likewise, the minority shareholders are also entitled to leave the company and require the acquirer to purchase their shares, subject to conditions. For companies whose capital is open to investment by the public specifically, a ‘squeeze out’ regime is foreseen under the Portuguese Securities Code, which is slightly different than the regime provided by the Companies Code.

The Companies Code provides a particularly important rule on the liability of companies for the debts of wholly owned subsidiaries. Pursuant to this rule, a company, upon acquiring 100 per cent of the share capital of another company (whether directly or indirectly with persons or entities acting in concert with it), becomes jointly and severally liable with the subsidiary for the latter’s debts. The interpretation of some aspects of this rule is however a matter of debate.8

In private limited liability companies by shares (SA companies), the general shareholders’ meeting or the sole shareholder is only allowed to resolve management matters (other than specific structural matters, which by law require the approval of the general shareholders’ meeting) if requested by the board of directors to do so. In private limited liability companies by quotas (Lda companies), it is generally understood that managing directors are required to follow any instructions issued by the general shareholders’ meeting or sole shareholder.

**Minority shareholder protection**9

The Companies Code contains several provisions that seek to protect the interests of minority shareholders.

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8 Specifically, the following aspects are debatable: whether the holding entity and the subsidiary must both have their registered office in Portugal for the joint and several liability to exist, or whether such liability exists even if the holding entity is located abroad; which debts are covered by the joint and several liability regime; and the moment when the holding entity ceases to be jointly and severally liable.

9 This section only provides a brief summary of minority shareholder protection under Portuguese companies law.
In Lda companies, any shareholder is entitled to require the managing directors to call the general shareholders’ meeting or to add items to the agenda. In SA companies, shareholders holding at least 5 per cent of the share capital are entitled to request the chairperson of the general shareholders’ meeting to call the meeting or to add items to the agenda (in SAs that are listed companies this threshold is 2 per cent).

As a general rule, resolutions at the general shareholders’ meeting are approved with a majority of the votes cast. However, and without prejudice to any further voting requirements that may be included in the articles of association, the following matters, among others, must in principle be approved by a majority of votes corresponding to at least 75 per cent of the share capital in Lda companies or two-thirds of the votes cast in SA companies: amendments to the articles of association (including share capital increases), mergers, demergers, conversion into another form of entity and dissolution.

In Lda companies, any shareholder is entitled to send the managing directors an information request on how the company’s affairs are being managed. The managing directors are then required to fulfil such information requests, and provide true, complete and clarifying information, as well as to allow the shareholder to examine the accounts, books and other documents of the company at the registered office. These information rights may be subject to some regulation in the articles of association, provided that such regulation does not frustrate or unjustifiably curtail such rights. If a shareholder uses the information to the detriment of the company or of the other shareholders, it will be liable for any damages caused and may also be subject to compulsory loss of its equity. Furthermore, the managing directors can deny access to the information if there are concerns that the shareholder will use the information for purposes alien and harmful to the company, or whenever disclosure can breach legal secrecy obligations.\(^\text{10}\)

In SA companies, any shareholder holding at least 1 per cent of the share capital of the company may examine, for duly justified reasons, the following information at the company’s registered office:

- management reports, accounts and related documentation for the three preceding years;
- calling notices, minutes and attendance lists for general shareholders’ meetings and bondholders’ meetings held during the three preceding years;
- information on the compensation paid during the three preceding years to the members of the corporate bodies and to the five or 10 employees with the highest compensation, depending on how many employees the company has; and
- share registers.

In the 15 days preceding any general shareholders’ meeting, any shareholder is also entitled to examine the information set out in the Companies Code, particularly background information on the members of the corporate bodies to be appointed at the meeting and the accounts to be approved in the meeting. Furthermore, any shareholder holding at least 10 per cent of the share capital may send the board of directors written information requests concerning the company’s affairs. These requests may only be denied if there are reasons to

\(^{10}\) If the information request is rejected, the shareholder is entitled to seek remedies, notably to require the general shareholders’ meeting to approve the disclosure of the information or to ask for a court-conducted inquiry on the company.
believe that the information will be used to the detriment of the company or of a shareholder, where the disclosure is in itself detrimental to the company or to its shareholders, or where the disclosure would entail a breach of legal obligations of secrecy.\footnote{Similarly to Lda companies, if a shareholder's information request is rejected, the shareholder may ask for a court-conducted inquiry on the company.}

In both Lda and SA companies, at least half of the distributable financial year-end profits must be distributed to the shareholders, unless the articles of association state otherwise or unless a shareholders’ resolution determining the contrary is approved by at least 75 per cent of the share capital of the company.

On specific grounds set out in the Companies Code, and subject to material and procedural conditions, shareholders are entitled to request a court of law to declare the nullity of a shareholders’ resolution or to annul a shareholders’ resolution. Particularly, minority shareholders are entitled to request a court to annul a shareholders’ resolution that is aimed at ‘allowing one of the shareholders to acquire special advantages for itself or for third parties, in detriment of the company's interests or the interests of other shareholders, or to cause harm to the company or its shareholders, unless it is provided that the resolution would still be adopted without the abusive votes’.

Finally, shareholders holding at least 5 per cent of the share capital of the company (or 2 per cent in the case of listed companies) may file a lawsuit against company directors requiring such directors to indemnify the company for any damages caused by them in the exercise of their functions. This right is supplementary to that of shareholders to action against directors for damages directly caused to them.

The articles of association of the relevant company may include other protection.

**Structuring considerations**

Normally, in cases of foreign investments, transaction structures are designed taking tax considerations into account, and particularly the taxation of dividends and capital gains on exit.

In this regard, Portuguese companies may benefit from Portugal’s broad double tax treaty network, the Parent–Subsidiary Directive, the Interest and Royalties Directive and the Merger Directive.

Moreover, the Portuguese tax framework also provides, under certain conditions, for a domestic participation exemption regime on dividends and capital gains that allows an efficient channelling of investments to non-EU countries.

**ii Fiduciary duties and liabilities**

Pursuant to Portuguese law, directors have both a generic duty of care, having to carry out the company’s management with a degree of ‘dedication, technical competence and knowledge of the company’s activities that adequately matches the office held by them’, applying the same level of diligence that would be applied by a ‘sound and organised manager’;\footnote{The standard duty of care is deemed to have several ramifications, including a duty to monitor, a duty to adopt reasonable decision-making processes and a duty to adopt reasonable decisions.} and a generic duty of loyalty,\footnote{The standard duty of loyalty is also considered to have several ramifications, such as a duty to refrain from self-dealing, a duty to not compete and a duty to not take corporate opportunities.} having to act ‘to the exclusive benefit of the company, taking into account the long term interests of the shareholders and other stakeholders who are relevant
for the company’s sustainability, such as employees, creditors and clients’. In addition to these two generic duties and their ramifications, other duties are foreseen under Portuguese law. Furthermore, the relevant company’s articles of association may include specific duties.

As a general rule, directors may be liable to a company for damages caused to it in the exercise of their functions unless they prove that they acted without guilt. However, a business judgment rule exists under the Companies Code pursuant to which no liability arises for the directors if they prove that they acted with ‘proper information’, ‘free of any personal interest’ and according to ‘criteria of business rationality’.

Directors are jointly and severally liable for damages caused to the company. Exceptionally, directors that were absent from a board meeting where decisions that caused detriment to the company were adopted, or which attended such meeting but voted against the decision and recorded their disagreement in writing, are exempt from liability. None of the directors is liable whenever their actions were based on decisions adopted by the shareholders, even if the relevant shareholders’ resolution is subject to being annulled.

A lawsuit against the directors for damages caused to the company requires a shareholders’ resolution approved with a simple majority of the votes cast or, as mentioned above, by shareholders holding at least 5 per cent of the share capital (or 2 per cent in listed companies).

Directors may also be liable to creditors of the company for being guilty of non-compliance with the applicable legal or contractual provisions that aim to protect creditors’ interests (e.g., restrictions on distributions) whenever this leads to the company’s assets becoming insufficient to pay off its debts. If directors are liable against the company, creditors may also, by subrogation, substitute the company and file a lawsuit against the directors, requiring them to indemnify the company for the damages caused. In addition, directors may also be liable to shareholders or third parties for damages directly caused to them in exercising their functions.

Furthermore, pursuant to the Companies Code, ‘all rules relating to liability of directors apply as well to any other persons to whom management functions were entrusted’. It is generally understood that this rule allows the filing of lawsuits not only against high-ranking officers but also against de facto directors and shadow directors, including shareholders and staff of shareholders that have exercised significant influence in the management of the company.

Pursuant to the Companies Code, a shareholder that (in light of the number of votes it has) is entitled, whether alone or in concert with other shareholders under a shareholders’ agreement, to appoint a director or a member of a supervisory body, is jointly and severally liable with such director or member of the supervisory body for damages caused to the company or to the shareholders in the case of culpability in the choice of the individual concerned, and if the appointment was approved with the votes of such shareholder and less than half of the votes of the other shareholders. Furthermore, any shareholder that, in the same way, is entitled to dismiss or request the dismissal of a director or member of a supervisory body of a company, and uses such influence to cause a director or member of supervisory body to commit any actions or omissions, is jointly and severally liable with the relevant individual for any damages caused to the company or its shareholders by such actions or omissions.

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14 See the two preceding footnotes.
Finally, it should be noted that a Portuguese company that is a wholly owned subsidiary of another Portuguese company is entitled to require the former parent to indemnify it for any year-end losses that, for any reason, the subsidiary suffered during the period in which it was held by the parent if such losses were not offset against any accounting reserves generated during that time. This claim can only be made after the end of the 100 per cent ownership relationship, or beforehand if the subsidiary is declared insolvent.

III YEAR IN REVIEW

i Recent deal activity

Both foreign sponsors and local sponsors were active in the Portuguese market in 2016, either completing deals or showing public interest in the acquisition of Portuguese companies.

The envisaged sale of the share capital of Novo Banco by the Portuguese banking sector resolution fund has attracted the interest of several foreign private equity houses. Apollo Global Management and Centerbridge Partners are reported to have submitted a joint offer to purchase the bank in 2016. Likewise, Lone Star Funds is reported to have also submitted an offer and to be negotiating the purchase of the bank at the time of writing. Both Apollo Global Management and Lone Star Funds have already acquired assets in Portugal in the past.

The Carlyle Group completed a deal in 2016 with the shareholders of Logoplaste, a Portuguese global manufacturer of rigid plastic packaging products. The fund managed by this sponsor is said to have acquired a 60 per cent interest in Logoplaste.

Bridgepoint Capital reached an agreement at the end of 2016 to purchase Sapec Agro Business. This transaction was completed at the start of 2017.

Several transactions concerning the sale of interests in renewable energy assets took place in 2016, with funds having submitted bids.

Deals signed or completed by Portuguese sponsors recently include:

a the acquisition of Aleluia Cerâmicas by a fund managed by Oxy Capital;

b the sale of an interest held by a fund managed by Explorer Investments in Nutricafés;

c the acquisition by a fund managed by Inter-Risco of an interest of approximately 40 per cent in the share capital of Catari;

d the acquisition by a fund managed by Inter-Risco of ExpressGlass and Axial;

e the sale of Generis by Iberian sponsor Magnum Capital Industrial Partners.

ii Financing

There is currently limited acquisition financing available from the Portuguese banks, which seem to be reluctant to take this type of risk, likely in part as a consequence of liquidity constrains. Foreign sponsors that are involved in large deals may be (and are usually) able, however, to obtain financing in international bond or syndicated loan markets.

In any case, acquisition financing and security packages need to be structured to ensure compliance, notably, with Portuguese financial assistance rules.

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15 Novo Banco, SA is a ‘good bank’ created as a consequence of the application of a resolution measure to Banco Espírito Santo, SA further to a decision adopted by the Portuguese Central Bank on 3 August 2014.
iii Key terms of recent control transactions

With regard to price adjustment mechanisms, both completion accounts and locked box mechanisms are used in Portugal (with locked box mechanisms continuing to become more popular).

Material adverse change clauses are used in Portugal, although their inclusion or non-inclusion, and the terms for their operation (if included), very much depend on the relative bargaining power of the parties. Earn-outs and similar clauses are also used, again depending on the relative bargaining power of the parties (and the initial commercial understanding between them).

There seems to be a recent trend for share sale and purchase agreements to include provisions stating that the clauses that govern compensation for breach of representations and warranties are the only remedy available to any of the parties in such cases, and that the parties expressly waive any other remedies available under the Portuguese Civil Code. The validity of these clauses is debated, and the same have yet, to the best of our knowledge, to be tested before the Portuguese courts.

IV REGULATORY DEVELOPMENTS

The Portuguese Securities Market Commission (CMVM) is the national authority having supervisory responsibilities in relation to the private equity sector in Portugal under Law No. 18/2015, of 4 March (the PE legal framework), which transposes Directive No. 2011/61/EU of the European Parliament and of the Council of 8 June on alternative investment fund managers into Portuguese law.

The CMVM has a broad range of prerogatives to enable it to conduct its supervisory role (including investigation powers). These prerogatives are listed in the Securities Code, with some specificities being included in the PE legal framework.

Pursuant to the PE legal framework, in exercising its supervisory role, the CMVM must take into consideration any guidance issued by the European Securities and Markets Authority.16

No specific authorisation is required per se for a private equity fund to complete a divestment transaction, although, as mentioned above, some sectoral requirements may apply (e.g., no opposition from the Portuguese Central Bank to sales of qualified interests in credit institutions), and antitrust clearance from the Portuguese Competition Authority or from the European Commission if the transaction is to meet or exceed certain concentration thresholds.

V OUTLOOK

Recent economic statistics and predictions seem to indicate that, although Portugal’s economic recovery will be slow, the situation is improving, and indicators are expected to see at least modest but consistent progress in the future.

Lisbon’s thriving startup scene is gaining increased international recognition, as exemplified by the city hosting the 2016 edition, and in all probability the 2017 edition, of

the Web Summit. While it remains to be seen whether the startup scene actually develops and manages to gain momentum in Lisbon, the venture capital industry could face parallel growth.

At the time of writing, several Portuguese companies are facing financial difficulties or are undergoing restructuring. Such market factors may continue to attract the interest of sponsors, including those specialised in distressed investments.

Finally, there also seems to be a trend of Portuguese companies seeking to reduce their financial indebtedness. As such, as firms attempt to deleverage, sales of non-strategic assets may start to emerge, generating investment opportunities for funds.

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17 www.websummitlisbon.pt/homepage.
Chapter 20

SINGAPORE

Andrew Ang, Christy Lim and Quak Fi Ling

I OVERVIEW

i Deal activity

In 2016, Singapore remained the leading dealmaker in Southeast Asia, driven by significant outbound acquisitions by the country’s sovereign wealth funds and corporates. According to a report by corporate finance adviser Duff & Phelps, Singapore recorded an increase in total M&A deal volume in 2016 with 684 deals compared with 591 deals in 2015, but deal value declined from US$101.2 billion in 2015 to US$82.7 billion in 2016. Significant acquisitions include acquisition by a consortium comprising Temasek Holdings Pte Ltd (Temasek), DBS Bank and other investors of a minority stake in Postal Savings Bank of China valued at US$7 billion, acquisition by sovereign wealth fund GIC Private Limited (GIC) and other investors of Asciano Ltd for US$6.8 billion and CMA CGM’s S$3.4 billion acquisition of Neptune Orient Lines Limited.

The real estate sector accounted for 30 per cent in value terms, overtaking the technology sector as the biggest contributor. Notable deals include GIC acquiring P3 Logistic Parks for €2.4 billion and sovereign wealth fund Qatar Investment Authority acquiring BlackRock Inc’s Asia Square Tower 1 for US$2.5 billion.

Private equity (PE) and venture capital investments in Singapore in 2016 have also been active, reaching the highest transacted values and deal volumes in the past five years. Such investments are predominantly minority stake investments rather than big buyouts. Technology is the top contributing sector, led by investments such as Softbank Group Corp

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1 Andrew Ang, Christy Lim and Quak Fi Ling are partners at WongPartnership LLP.
and other investors’ investment in GrabTaxi Holdings Pte Ltd valued at US$750 million.\(^{10}\) Other notable PE investments include acquisition by GIC, Bain Capital Partners LLC and Advent International of a minority stake in Singapore-headquartered QuEST Global Engineering Pvt Ltd for US$350 million\(^ {11}\) and Baring Private Equity Asia’s S$450 million acquisition of Singapore listed Interplex Holdings Ltd.\(^ {12}\)

In terms of exits by PE investors and sovereign wealth funds, notable examples include Temasek’s proposed sale of a 21 per cent stake in Intouch Holdings and its 7.39 per cent stake in Bharti Telecom for a total consideration of S$2.47 billion to Singtel\(^ {13}\) and EQT’s sale of its 49 per cent stake in Econ Healthcare back to its founders.\(^ {14}\)

ii Operation of the market

In the Singapore market, the main exit routes adopted by PE sponsors are through a trade sale of the target company or a public flotation of the target company’s shares, which is often accompanied by a secondary offering of vendor shares held by PE sponsors.

When there is volatility in the capital markets and uncertainty over timing for a successful listing, PE sponsors who would have preferred an exit via public flotation may turn to a sale process instead. A 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 four stages.

1. 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.

\(^ {10}\) ‘Grab’s record $750m funding turns up the heat on Uber’ (20 September 2016): www.dealstreetasia.com/stories/grabs-record-750m-funding-turns-up-the-heat-on-uber-53782/.
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). Increasingly, demand for warranty and indemnity insurance comes into play to mitigate deal risk for PE firms. 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 which 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 hold 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. The PE sponsor may also set aside a portion of its shareholding in the bidding vehicle to establish a share incentive scheme where such 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 the management leaves the employment of the target company. Such moratorium or restrictions would usually be at least for a period that coincides with the anticipated period of time that the 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 in order 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 vary depending on the objectives of a PE sponsor, whether it is to acquire a minority interest, a majority interest or 100 per cent control of the target company. 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 Singapore Code on Take-overs and Mergers...
(the Take-over Code) or a scheme of arrangement (SOA) subject to both the Take-over Code and the Companies Act (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 strict timeline 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 announcement) and the target company is then obliged to respond with an offeree document (within 14 days after 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 Securities Industry Council of Singapore (SIC), the offer will either lapse as a result of such conditions not being satisfied, or close successfully.

A SOA generally involves a longer transaction timeline, due mainly to 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, a 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 need to apply to the High Court of Singapore for leave to convene a meeting of the shareholders to consider the scheme (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 (ACRA). Unless an objection is raised at the court hearing, a SOA is likely to take effect about 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). A 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, a 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 to end up with a majority stake in a listed entity (which is still subject to listing rules and other compliance requirements). If the target company is not a Singapore-incorporated company, the provisions in the Companies Act relating to SOA and compulsory acquisition will not be applicable. In such cases, 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, 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 PE sponsor wishes to have the target company delisted from the SGX (and be no longer subject to listing rules and other compliance requirements) even if it will not be assured of acquiring 100 per cent of the target company after the close of the exit offer.

The framework for acquisition of private companies by PE sponsors is dependent on the requirements or restrictions in the constitution of the company (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 sought or the timing upon which these processes are carried out.

Tax-related issues tend to drive the deal structure (in particular, holding structure and domicile of an acquisition vehicle) on a cross-border going-private or PE transaction, as parties seek to minimise the tax costs of the acquisition as well as tax leakages in the existing operations. Specifically, the impact of withholding taxes on dividends, local taxes, distributions and interest payments and restrictions on the PE sponsor’s ability to repatriate earnings should be taken into account when structuring such cross-border transactions.

A PE sponsor looking to implement a leveraged transaction would also have to consider the laws in the jurisdiction where the target company and its assets are located, as these may prohibit or restrict companies in the relevant jurisdictions from providing financial assistance in the form of security arrangements or guarantees for the acquisition financing. These limitations may compel the PE sponsor to procure separate bank financing in a jurisdiction outside of 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 such 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 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 listing rules of the SGX as well as the principles and guidelines of the Code of Corporate Governance.

The Corporate Governance Council (Council) was established by the Monetary Authority of Singapore (MAS) to promote a high standard of corporate governance in listed companies in Singapore, so as to enhance Singapore’s reputation as one of the foremost
financial and business hubs on a global scale and to boost the confidence of prospective and current investors. The Council acts as an adviser to the MAS, ACRA and the SGX regarding corporate governance issues and rules that apply to listed companies in Singapore. The Code of Corporate Governance includes guidelines that, \emph{inter alia}, concern the element of independence of the board of directors where the definition of ‘independent director’ includes a director with no relationship with the company, its related corporations, its 10 per cent shareholders or its officers that could interfere or be perceived to interfere with his or her independent business judgment. These guidelines underpin the prevailing sentiment in the business community to continuously raise the standards of corporate governance. In a similar vein, the prohibition against the improper use of any information acquired by virtue of a person's position as an officer or agent extends to cover the improper use of a person's position as an officer or agent of the company, to gain an advantage for himself or herself or any other person, or to cause detriment to the company. Thus, any representative of a PE sponsor who sits on the board of a portfolio company should not neglect the interests of minority shareholders while discharging his or her duties towards his or her appointor, and should be especially careful not to be seen as abusing his or her position regardless of whether he or she has obtained information from the portfolio company.

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 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 insider-trading laws, if a party is in possession of price-sensitive information (PSI) in relation to a company that is not generally available, such a party is prohibited from trading (and from procuring another person to trade) in the company’s securities. A contravention of such 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 such 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.15 A list of top M&A deals in Singapore in 2016 include:16

a Temasek, DBS Bank and other investors acquiring a 16.9 per cent stake in Postal Savings Bank of China valued at US$7 billion;
b Tata Communications’ sale of a 74 per cent stake in Tata Communications’ data centre business in India and Singapore, worth approximately US$640 million to ST Telemedia;
c Easton Overseas Limited’s offer for all issued shares and convertible bonds of China Merchants Holdings (Pacific) Limited, valued at S$1.5 billion;
d EFG BANK AG, Singapore Branch’s acquisition of BSI Bank Limited’s Singapore private banking business;
e Temasek’s S$1.2 billion acquisition of SMRT Corporation Ltd;
f Temasek’s sale of a 21 per cent stake in Thailand’s Intouch Holdings Public Company Limited and a 7.39 per cent stake in India’s Bharti Telecom Limited, to Singapore Telecommunications Limited for an aggregate consideration of S$2.47 billion; and
g Qatar Investment Authority acquiring a 100 per cent stake in Asia Square Tower 1 valued at US$2.5 billion.

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 and other forms of financing being less common.17 In most conventional financings, the basic lending structure mostly comprises debt, with equity investment by management and investors and other sources 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 provides 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 upfront. 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 common 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

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involvement of the target company in the financing structure, financial assistance restrictions in Singapore present additional issues for leveraged buyout and other financing arrangements that are secured by assets of, or expected to be repaid from cash flow of, a 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.

**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 would usually rank behind the senior tranche and may also be structurally subordinated. In return, mezzanine lenders and direct lenders expect a higher margin and incentives via equity kickers such as warrants (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, which in turn represents higher and more attractive returns to mezzanine lenders. 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;

**Bonds**

In larger financing transactions, the mezzanine debt may be replaced or refinanced by high-yield bonds. The minimum size of a high-yield bond issue usually falls within the higher region in order to create sufficient liquidity within the issue, and the use of this method of financing has been restricted to the higher buyouts. In the Singapore market, save for situations where 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 has existing bond issuances, is known in the market and have existing bond issuances or other debt that needs to be refinanced whether as a result of maturity or as a result of change-of-control triggers. At the higher end of the fundraising chain, 2016 also saw the issuance by Astrea, a Temasek-linked fund, of S$510 million worth of bonds backed by cash flows generated from its investments in private equity funds. While the proceeds of the issuance were expressed to be intended for the purposes of repaying existing shareholders loans, the subscription levels and the possibility of a similar retail issuance in the future suggest that there may be appetite in the market for private equity-linked debt issuances backed by significant sponsors that could then also be used to raise funding for acquisition war chests.18

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Where the market is favourable, bond issuances have been seen as a strong option for the refinancing of acquisition debt given the generally favourable terms in comparison to debt financing. That said, the fluctuating and changing nature of the bond market means that, in the context of the actual financing of purchase consideration juxtaposed with the need of acquirers for certainty of funding in relation to such financing, bond issuances have not been as prevalent for the purposes of funding the actual acquisition but remain more common as a post-acquisition financing option (although discussions of post-financing structures would have typically commenced prior to or during the acquisition process).

Composite financing structures
In recent years certain take-private deals involving a larger quantum of acquisition debt have seen principals structure the acquisition debt with a composite of various financing sources, coupled with the flexibility for incurrence of additional debt that may then be brought within the existing financing structure comprising the acquisition debt. A typical structure would involve a senior facility coupled with either one or more other facilities (mezzanine or otherwise), bond issuances and the ability to either increase borrowing limits in such other facilities or to bring in new facilities into the existing structure. Consequently, security sharing, subordination and intercreditor terms are issues that merit consideration and form the subject of fairly involved negotiations. As a practical measure, existing financiers to the target group may also be invited to participate in the composite structure in order to, amongst others, manage the risk of the lenders in these facilities triggering prepayment or default provisions as a result of the acquisition.

Notwithstanding these alternative financing structures, the continued liquidity in the lending market means that there is no clear upsurge in these other alternative financing sources as traditional debt financing continues to prevail.

Security structures
Financiers typically look to the assets of the target group in seeking to maximise its collateral pool. Whether it is able to enhance its security package is fundamentally premised on the twin key factors of the availability of the asset pool of the target group and (depending on the locality and the asset in question) the feasibility of taking such securities, bearing in mind the legal prohibitions and restrictions applicable in each relevant jurisdiction (including financial assistance issues). If the financiers consider the security package insufficient, they may at times require additional safeguards such as the provision of corporate or individual guarantees or support arrangements from parties related to the acquirer.

Notwithstanding the relaxation of the financial assistance prohibitions in Singapore, security or guarantees from the target group are generally expected to not be in place on or prior to funding and the completion of the acquisition as the acquirer would typically not have control over the target group at that stage and financial assistance restrictions may still apply to the extent that the target company remains a public company or a subsidiary of a public company. As such, depending on the security matrix, clean-up periods may still feature in financing documentation, although the timing for the provision of security
and guarantees by the target group has generally been shortened due to the absence of the need to conduct ‘whitewash’ procedures to lift financial assistance restrictions (assuming the target is taken private or was already a private company). 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 visibility of the acquirer on the assets of the target group and the restrictions (legal, contractual or otherwise) and encumbrances thereon. To the extent that such visibility is not forthcoming, the provision of security and guarantees by the target group needs to be assessed and clean up periods adjusted accordingly.

**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), such 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 such circumstances.

**Financial assistance**

In 2015, amendments to the Companies Act took effect resulting in the abolishment of financial assistance restrictions on private companies that are not subsidiaries of a public company. The relaxation on the prohibitions against financial assistance for private companies has eased the provision of security by targets and their subsidiaries that have successfully been taken private after completion of the acquisition. Private companies or companies that are taken private no longer need to undergo ‘whitewash’ procedures in order to provide financial assistance (e.g., by way of a debt pushdown or by providing security and guarantees).

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. These, however, remain restricted to deals where the target company is a private company (which is not a subsidiary of a public company) and are subject to the acquirer’s visibility of the target group’s assets.

The amendments to the Companies Act also introduced a new ‘whitewash’ procedure to allow a public company or its subsidiary to provide financial assistance. Adapted from Section 260A(1)(a) of the Australian Corporations Act 2001, the new Section 76(9BA) of the Companies Act allows financial assistance to be provided if, among other requirements, the following are fulfilled:

a the provision of financial assistance does not materially prejudice the company’s or its shareholder’s 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.
Australian 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.\(^{19}\)

It has been suggested (in line with the approach taken by some Australian authorities) 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;
- the nature of the transaction, in particular, whether it involves any actual or contingent depletion of the company’s assets;
- an assessment of all the interlocking elements of the transaction; and
- an assessment of where the net balance of financial advantage lies;

\(b\) 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 cashflow and balance sheet;

\(c\) the opinion of the directors or any independent experts on the impact of the transaction; and

\(d\) any actual loss suffered by the company as a result of the transaction.

Although the ‘no material prejudice’ whitewash method has been used (albeit sparingly) in Singapore since its introduction, it remains to be seen, however, whether such 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. Until greater clarity is achieved on the applicability of the new whitewash method along with guidance on the adoption of this method, financial assistance remains a live and key issue in acquisition deals involving public companies and their subsidiaries.

**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.\(^{20}\) 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 and 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.

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 iii  **Key terms of recent control transactions**

A PE sponsor whose objective is to privatise a listed company (i.e., an ‘all or nothing’ outcome) but does not wish to do so by way of a SOA (because of the protracted timeline and process) may do so by way of a general offer that is conditional upon a higher minimum acceptance threshold of 90 per cent. By pegging the minimum acceptance condition to the compulsory acquisition threshold under Section 215(1) of the Companies Act, the PE sponsor either privatises the target company or walks away if the acceptance condition is not met.

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 which 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. Due to the potential lengthy process of merger control filings, takeovers of listed companies have to be structured as a 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).

In making an exit, a PE sponsor that is seeking to exit in line with its investment time frame would likely 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 such 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 such 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 consequentially 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 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 Companies Act

The last round of significant amendments to the Companies Act was passed in 2014 and the amendments came into effect in two phases. The first tranche of amendments came into effect on 1 July 2015 and one of the key amendments relates to financial assistance as mentioned above.

The second tranche of amendments came into effect on 3 January 2016 and some of the key amendments that may impact M&A activities are:

a the extension of the right to issue shares with different voting rights (previously only allowed for private companies) to public companies to give them greater flexibility in capital management. The SGX is currently reviewing the issue of whether to allow SGX listed companies to adopt a dual class share structure and to issue non-voting shares and shares with multiple votes;

b the compulsory acquisition mechanism under the Companies Act that allows the bidding vehicle a means to squeeze out not only the holders of shares, but also the holders of options and convertibles; and

c the amalgamation provisions under the Companies Act no longer require the board of directors of each amalgamating company to provide a 12-month forward-looking solvency statement of the amalgamated company. This will address the difficulty and reluctance of directors of two amalgamating companies to provide a 12-month forward looking solvency statement when the board of the amalgamated company may adopt a different business strategy moving forward. With this change, more companies may be prepared to consider amalgamation as an alternative M&A structure.

In 2016, further amendments to the Companies Act were being proposed. One aspect relates to the updating of Singapore’s corporate insolvency laws and enhancing of debt restructuring framework to meet modern day business needs and another aspect relates to company administration to reduce the regulatory burden and improve the ease of doing business, as well as enhancing the transparency of business entities.21 One of the key proposed amendments relates to the requirement for companies (other than SGX listed companies and Singapore financial institutions) and limited liability partnerships incorporated or registered in Singapore to obtain and maintain information on their beneficial owners and controllers. This disclosure regime (which has already been adopted in the UK) seeks to ensure that Singapore’s business transparency regime meets the international standards set by the Financial Action Task Force and the Global Forum on Transparency and Exchange of Information for Tax Purposes. It remains to be seen whether this will affect the attractiveness of Singapore as a jurisdiction for incorporation of companies.

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ii Take-over Code

The Take-over Code was amended on 25 March 2016. Some of the key amendments that may impact M&A activities include:

a introducing a deadline for a potential competing offeror to clarify its intentions (‘put up or shut up’) by either announcing a firm intention to make an offer or making a ‘no intention to bid’ statement;

b introducing an auction procedure for the resolution of competitive situations;

c requiring prompt announcement of any material changes to information previously published in connection with the offer or material new information which would have been required to be disclosed in any previous document published during an offer period, had it been known at the time; and

d clarifying that when considering an offer, an offeree board may consider the feasibility of soliciting a competing offer or running a sale process as well as the availability of management projections and forecasts that can be shared with the independent adviser for the purpose of the latter’s advice on the offer.

These amendments provide greater certainty on the applicable procedures and timelines in the event of competing offers and for those offeree company boards who desire to take a more active role in safeguarding shareholders’ interests.

iii SFA

The Securities and Futures (Amendment) Bill 2016 was passed in Parliament on 9 January 2017. The Bill seeks to introduce a range of amendments to the SFA in relation to, among other things, over-the-counter (OTC) derivatives regulation, enhancing regulatory safeguards for retail investors, enhancing the credibility and transparency of the capital markets and strengthening the enforcement regime against market misconduct.

Some of the key amendments that are more relevant to M&A activities include:

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 material false or misleading disclosure that may wrongly influence persons to trade in the market, whether or not it has a significant price effect;22

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.23

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22 Monetary Authority of Singapore, ‘Response to Feedback Received – Proposed Amendments to the Securities and Futures Act (Part XII & Section 324)’ (November 2016).

23 ‘Securities and Futures (Amendment) Bill 2016’ – Second Reading Speech by Mr Ong Ye Kung, Minister for Education (Higher Education and Skills) and Second Minister for Defence, on behalf of Mr Tharman
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 for breach of such laws.

From the perspective of access to financing for PEs, it may be noteworthy that the US has introduced guidance on leveraged transactions since March 2013 and that the European Central Bank has also recently in November 2016 launched a public consultation on similar guidance. Given that the guidance at present is restricted to the US and possibly European banks going forward, there is no visibility as to whether this will translate to similar guidance in Singapore to reflect international practices, and if so, whether this would have an impact on the ease of access to the traditional financing source of bank lending in Singapore. To the extent that financial institutions are already within the parameters proposed by any guidance, impact, if any, on access to financing may be minimal.

V  OUTLOOK

It is difficult to predict the outlook for local M&A activity in 2017 due to the macroeconomic uncertainties. Among other things, it would be hard to know the outcome of Brexit negotiations or the aftermath following the 2016 US presidential elections. 2016 has seen a fall in deal value as compared to 2015, and it may be the case that global M&A deal value could continue its decline in 2017. Nevertheless, we believe that Singapore, with its strategic location and established financial infrastructure, remains well poised to capitalise on any growth in the region.

Chinese investors’ increasing appetite for outbound acquisitions will also continue to fuel M&A activities in the region. However, in an effort to slow a surge in capital fleeing offshore and stabilise a declining yuan, China has issued regulatory rules to tighten supervision on outbound investments and restrict outbound investments by centrally controlled state firms. With certain overseas deals being subject to stricter review, it may slow down the pace of investment by Chinese investors.

On a more positive note, there are various successful technology start-ups that are headquartered in Singapore, with examples of Garena and Grab being highly valued and funded in the region. As Singapore continues to develop itself as a technology hub, we may see a rise of more success stories in Singapore and further boosts in M&A activity in relation to the technology sector.


I OVERVIEW

i Deal activity

In 2013, the parliament adopted a resolution under which it consented to the sale of 15 state-owned companies. The latter boosted M&A activity in Slovenia, which in consequence resulted also in an increase of foreign private equity entrances onto the Slovenian market. Despite the fact that in 2014 Slovenia underwent early elections, considered to be a turning point from the perspective of Slovenian state-owned asset management that could compromise the privatisation process, no major changes in the government’s commitments to divest have been detected since then. Moreover, in 2015 the parliament adopted the Ordinance on state asset management, which set forth conditions of asset management and classification of investments according to which the state will divest and privatise state-owned companies. All of the above therefore means that the privatisation of state-owned companies continues to be the key source of M&A activity in Slovenia. The parliament and the government therefore continue to support the privatisation process, whereby experience from recent transactions shows that the Slovenian Sovereign Holding (acting on the state’s behalf) in principle does not discriminate between private equity investors relative to traditional strategic industrial buyers.

According to our assessment and considering that no official data or statistics are available, the level of private equity transactions in 2016 remained at the level of previous years. After a decline between 2008 and 2012, private equity transactions gained momentum in 2014, and their level has steadily grown since then. According to some interpretations, the level of activity in 2016 exceeded the levels reached in 2007. However, such view may be subject to interpretation and discussion, since Slovenian Securities Market Agency data show that M&A activity in Slovenia in 2015 remained significantly lower than in the years prior to the financial crisis. However, our position regarding the level of private equity activity also takes into account the fact that the Slovenian Securities Market Agency does not include transactions that are not subject to the Slovenian Takeovers Act in its report. The latter means that the data analysed by the Securities Market Agency (although the only available data, and the best approximation to the actual market size and structure) do not include the vast number of smaller, yet still important, transactions. In addition, the numbers for 2007 also included management buyout transactions reflected in the extremely large market value data.

1 Gregor Pajek is a partner and Aljoša Krdžić is an associate at Rojs, Peljhan, Prelesnik & partners o.p., d.o.o.

– the data on the value of transactions in 2007 exceeded the yearly average in the years from 2002 to 2005 by more than three times. The data above and our experience in the field of structuring and advising on private equity transactions to various buyers suggests that private equity transactions are expanding and have taken over a significant portion of the M&A market in Slovenia.

ii Operation of the market

Operations of the private equity market in Slovenia do not significantly differ from the classical acquisitions carried out by traditional strategic (industrial) buyers. The standard sale process usually includes several phases, starting with addressing potential buyers with a teaser containing information about the target (when the state is selling its stakes in companies, public invitations to submit a bid are published to address a very broad investor base) followed by a stage during which an interest to purchase the investment is presented to the opposing party. The latter stage is usually followed by the execution of due diligence, a decision of the seller and the buyer as to whether they wish to enter into further negotiations on the terms of the deal, actual negotiations, the signing of the agreement and finally closing (completion) of the deal, which follows the fulfilment of conditions precedent, if applicable. The latter usually include obtainment of certain approvals and consents by regulatory agencies, if necessary. The length of the sales process depends on the structure of the transaction. Simple share sales in smaller companies may be finalised in a couple of weeks (starting with initial contact between the seller and potential buyer, and ending with the transfer of shares). On the other hand, completion of all major transactions takes longer, since they usually include comprehensive due diligence, buyers are required to obtain certain permits and (regulatory) approvals, and sellers usually perform negotiations with several potential buyers and, therefore, need more time to shortlist the bidders and finally adopt a decision on the best (the most suitable) bidder. In particular, sale processes involving state-owned companies may take longer until completion, even up to nine months.

Our experience enables us to say that investors (a private equity firm or fund that acquires the target) are striving towards achieving and ensuring smooth transition and integration. One of the important aspects of such transition is also the arrangements with the management of the target. In some cases investors decide to continue a business relationship with the incumbent management, whereas in other cases they wish to appoint new management. Slovenian legislation does not restrict incentives through management ownership. The content of such arrangements varies from one company to another and fully depends on the individual agreement between the shareholders and the management, whereby the Slovenian Companies Act expressly lists a shares and options remuneration scheme as a method of incentivising the management. Shareholders in a limited liability company may freely determine the remuneration for management, whereas in joint-stock companies shareholders may influence the remuneration and may incentivise management via a remuneration policy.

3 This is a very simplified ‘standard’ sale process. Recently we have seen also approaches where investors were invited to participate in a capital increase completion, which subsequently may trigger a mandatory takeover offer (to the extent the company falls under the definition of ‘target company’ set forth in the Takeovers Act).

4 Regulatory requirements are dealt with separately under Section IV, infra.
adopted in accordance with Paragraph 7, Article 294 of the Companies Act. If shareholders have not adopted the remuneration policy, the supervisory board still needs to follow the criteria set forth by the legislator with regard to the remuneration policy, and in this case it is up to the supervisory board to assess what the content of the management agreements will be.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The structure of the transaction depends most and foremost on the organisational form of the target company. The majority of transactions involve acquisitions of shares in joint-stock companies or business shares of limited liability companies, which are two of the most notable organisational forms of companies under the Companies Act.

When a specific private equity investment is made into a Slovenia-based company, the core of the transaction remains the same. This means that the sole acquisition of shares (the method and required step for the transfer of ownership over shares) depends solely on the organisational form of the target. If the private equity entity is buying a business share in a limited liability company, a sale and purchase agreement needs to be entered into in the form of a notarial deed whereby the transfer of the business share becomes effective (in relation to third parties and against the target itself – the acquirer obtains rights and obligations against the target) only after the buyer is entered in the court register (as the holder of the business share). On the other hand, if the target is organised in the form of a joint-stock company it is not required that the share sale and purchase agreement is entered into in any specific form other than that the agreement is in writing. In this case, the transfer of shares (stock) occurs after the acquired shares are entered in the buyer's dematerialised securities (trading) account held with the Central Clearing Corporation (having a position of a central securities depository) and operated by its member. In practice, parties usually agree on the delivery-versus-payment closing mechanism, including appointing an escrow agent (in the case of transfer of shares usually Central Clearing Corporation, in the case of transfer of business shares usually a public notary).

In addition, the structure of the transaction further depends on whether specific provisions of the Companies Act regulating the pre-emptive rights of other existing shareholders should be considered and applied, whether the target (which is organised as a joint-stock company) in its articles of association provides that the company needs to consent to the transfer of shares, whether the Slovenian Takeover Act applies (specifics of mandatory

5 Paragraph 7 of Article 294 of the Companies Act stipulates that the remuneration policy shall foster the long-term sustainability of the company and provide that the remuneration is commensurate with the results and the financial position of the company; that the total remuneration may be composed of a fixed and a variable part, whereby the variable part of the remuneration shall depend on measurable criteria defined in advance; and that severance pay may be paid only in the case of early termination of a contract.

6 The seller and the buyer provide their Central Clearing Corporation members with the bilateral orders (delivery and acceptance order, whereby these two orders need to be paired), and on the basis of such paired orders the Central Clearing Corporation transfers the shares from the seller's trading account on to the buyer's trading account. A list of Central Clearing Corporation members includes all major banks present in Slovenia and also some brokerage companies. The investor may choose freely which member of the Central Clearing Corporation will open a trading account on its behalf.
takeover offers are discussed in Section IV, infra), whether the transaction is subject to the merger control rules and whether any specific rules should apply due to the specifics of the business activities of the target.

All of the above means that there is no significant difference between transactions when the investor is acquiring control over the target and transactions when the investor acquires only a minority stake. The main differences are related to the question of whether the transaction is subject to the mandatory takeover rules and whether the transaction constitutes a concentration that might trigger the obligation to obtain a merger clearance.

There is also no material difference when the acquirer is domiciled outside Slovenia. Such acquirer should obtain a Slovenian tax number, in some cases (in asset deals where the acquirer obtains ownership over real estate) the acquirer should also obtain a registration number, and if the transaction refers to shares (stocks), then the acquirer should open a trading account with one of the Central Clearing Corporation members. Several recent acquisitions were conducted through special purpose vehicles (SPVs) established in Slovenia. All administrative issues that need to be resolved when a foreign investor is investing in Slovenian companies through a domestic SPV do not significantly and materially affect the transaction, since all stated procedures are relatively straightforward.

**ii  Fiduciary duties and liabilities**

According to Article 264 of the Companies Act, any person who uses his or her influence to induce members of the management or supervisory board, a procurator or proxy to act to the detriment of a company or its shareholders shall compensate the company for the resulting damage. Although there is no explicit case law that would deal with situations when such third person would be another shareholder, Slovenian legal theory advocates that even shareholders should be held liable for their unlawful influence on the company’s operations, and that in most cases majority shareholders would be held liable for forcing the management to act to the detriment of the company. This means that private equity investors in some situations might be held liable for damage incurred to the company due to their actions as shareholders. On the other hand, there is no uncertainty with regard to the existence of the fiduciary liability of the members of the management or supervisory board of the company. The members of the management or supervisory board may be held liable under Article 263 of the Companies Act, which sets forth the legal standard of their professional diligence. Managers and supervisory board members, regardless of their affiliation to a certain shareholder, must, while performing their duties on behalf of the company, act with the diligence of a conscientious and fair manager and safeguard business (and trade) secrets of the company. Such fiduciary duty of management and supervisory board members includes both their accountability towards the company, and their liability to creditors of the company.

**III  YEAR IN REVIEW**

**i  Recent deal activity**

As already discussed in Section I, supra, the private equity market in Slovenia remains vibrant, especially as a consequence of the increasing number of foreign private equity investments. The latter are dispersed throughout the extensive range of business sectors. The overall M&A activity depends vastly on the future development of the privatisation process (public-to-private transactions), whereby sales of (either majority or minority) stakes in smaller privately owned companies are also gaining importance in the search for new capital required for
growth and penetration on foreign markets. In addition, and which may be considered as specific to Slovenia in recent years, a significant increase in two-stage transactions may be detected. As a result of the recovery of the banking sector through sale of claims by the state-owned Bank Assets Management Company (BAMC), potential investors in the first stage buy the claims from the Bank Asset Management Company (and maybe also from some other privately owned foreign banks), then at the latter stage execute the capital increase by a debt-to-equity swap, thereby acquiring the target.

Since no official aggregate data on the volume and value of the private equity transactions in Slovenia are available and considering that the official data include various transactions (and not only private equity), we will discuss only the major private equity deals that were executed (but not necessarily finalised and closed) in 2015 and 2016. For example, in 2015 Slovenian Sovereign Holding entered into a share sale and purchase agreement with funds managed by Apollo Global Management, and the European Bank for Reconstruction and Development announced the sale of a 100 per cent share in Slovenia’s second-largest bank, Nova KBM, for €250 million, which represents a first sale in the process of the privatisation of state-owned banks. Apollo Global Management has also acquired the Slovenian branch of Raiffeisen Bank (the value of the transaction was not publicly revealed). Among the companies acquired by private equity investors in 2015 (according to information already in the public domain) are the Slovenian national airline carrier, Adria Airways, which was acquired by 4K Invest for €1.1 million, and the sports equipment manufacturer Elan, which was acquired by Merrill Lynch International and Wiltan Enterprises Limited for approximately €12 million.

In 2016, the market remained vibrant. Mercator (the largest Slovenian retailer) divested and sold its sports retail franchise company INTERSPORT ISI to the Polish Enterprise Investors (Fund VII) for €34.5 million. BAMC entered into an agreement with York Global Finance Offshore BDH for the sale of claims towards a group of affiliated companies – DZS (a leading wholesaler and retailer of office supplies), Delo Prodaja (a leading distributor and seller of magazines and other papers in Slovenia) and Terme Čatež (the largest Slovenian natural health resort) – which might represent phase one of an anticipated takeover of listed assets (claims were transferred onto York Global Finance in January 2017). One of the largest transactions (by value) in 2016 was the sale of Cimos (one of the largest manufacturers of various engineering products in Central Europe) to TCH Cogeme (part of Palladio Finanziara group) for €110 million. In recent weeks, however, various information regarding the transaction has emerged, since Slovenian Sovereign Holding and BAMC are struggling to procure fulfilment of one of the crucial conditions precedent for closing. The transaction is

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7 The BAMC is a joint-stock company that was established in March 2013 as a company owned by the Republic of Slovenia with the task of facilitating the restructuring of banks with systemic importance that were facing severe solvency and liquidity problems. By the end of 2013, the two largest banks had been recapitalised by the government, and a substantial part of their non-performing assets had been transferred to the BAMC (source: www.dutb.eu/en/about-us). The BAMC is also referred to as the ‘bad bank’.
therefore still pending, and the outcome (closing) is not clear at the time of writing. After the unsuccessful attempt of Slovenian Sovereign Holding to sell a leading regional manufacturer of hygiene tissue, Paloma, through a capital increase by Abris Capital Partners in 2015 and early 2016,15 Slovenian Sovereign Holding continued its efforts and eventually reached an agreement with Slovakian Eco-Invest private equity to participate in Paloma’s capital increase in an amount of €18.2 million and thus acquire 57.2 per cent share in the company.16

In addition to the above-mentioned transactions, there were several other private equity market entrances in 2016 and, although details of those transactions may not be disclosed, according to our estimates the aggregate value of these transactions is roughly €80 to €100 million.

ii Financing

The question of financing private equity transactions has raised many issues in the past in Slovenia. Debt and leveraged finance has been seen in certain notable transactions. In addition, we can also say that a significant number of those debt financing transactions, especially where acquirers come from Slovenia or regional countries (Bulgaria, Croatia, Serbia, etc.), constitute leveraged buyouts. The sources of such financing are diverse and vary from transaction to transaction. In general, buyers obtain debt finance from bank loans or bonds issuances. In some cases transactions are also financed through mezzanine and second lien financing.

Pursuant to the Companies Act, any transaction resulting in financial assistance of a joint-stock company (to the buyer of its shares) is null and void, and therefore the target company may not provide finance or security for acquisition of its shares. The latest 2015 amendment of the Takeover Act similarly imposes also the obligation of the buyer (the offeror) to prove to the Securities Market Agency (in the procedure for the issuance of permission to announce a mandatory takeover offer) that the target’s assets are not used and shall not be used (directly or indirectly) as collateral for obligations arising from acquisition finance used as consideration in the takeover. The same obligation applies also to the target shares (subject to the mandatory takeover offer) that are not yet held (owned) by the offeror. As a result, the offeror must not grant or undertake to grant a pledge over such shares as security for acquisition financing.

In cases where the target company is a limited liability company, the financial assistance rules are significantly different. As a general rule, a limited liability company could not pay to its shareholders any payment to the extent that such payment would affect the company’s assets required for maintenance of the company’s registered capital and restricted reserves (capital maintenance rule). In effect, a limited liability company could grant security for acquisition finance, but only to the extent and provided that such security does not affect the assets in value equal to the amount of the registered capital and restricted reserves. This results in permissible security for limited liability acquisition finance to the extent of assets in value equal to the value of distributable profit and distributable reserves. The new LLC financing rule now explicitly sets forth that any of the following do not count in the amount of the assets required to maintain the amount of the registered capital:

\[
\begin{align*}
& a \quad \text{a shareholder loan;} \\
& b \quad \text{a loan to any member of the management (or its family member); or}
\end{align*}
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iii Key terms of recent control transactions

As far as the terms of recent control transaction agreements are concerned, almost all acquisition agreements contain provisions that regulate the closing procedures (if the finalisation of the acquisition is conditioned with closing), provide for the warranties of both parties, and set forth the mechanism and rules for the indemnification. Particularly in recent transactions, representations and warranties provisions have gained importance, which is a result of foreign buyers being lenient towards such provisions. Provisions on the conditions precedent are sometimes extensive and comprehensive, which is especially true in regard to transactions in which the acquirer needs to obtain certain permissions or when the seller undertakes that the company will divest non-core business assets. However, the terms of each individual transaction are negotiated according to the needs of the seller or the buyer and considering the specifics of each transaction. This means that no provisions are per se included in or excluded from the transaction documentation.

Certain changes in trends in 2015 and 2016, mostly related to the fact that quite a considerable number of deals related to the recovery of the banking sector through sales of claims, may be detected. In this context, we have seen a lot of acquisition opportunities related to carve-outs or asset deals. Furthermore, the structure of several deals in 2015 and 2016 included some type of capital increase, and the providing of working capital to the target or refinancing of the target's financial debt significantly affected the key terms of the transaction. Last but not least, deferred consideration or earn-out provisions and price adjustment mechanisms formed a significant portion of transaction negotiations.

iv Exits

No notable exits occurred in 2016. There were several smaller exits of both Slovenian-based and foreign private equity funds that divested their investments mostly in state-owned companies that were sold in 2015 and 2016. However, according to our information, all such private equity investors remain involved in the Slovenian private equity market; therefore, their exits from certain portfolio investments cannot be considered exits from Slovenia.

IV REGULATORY DEVELOPMENTS

As already discussed in Section II.i, supra, the structure of a transaction depends on various factors. Among those factors that significantly affect all aspects of the transaction (especially its structure and the timeline of the transaction) is the target's potential subjection to the special takeover rules provided in the Takeover Act. The provisions of the Takeover Act impose an obligation to make the mandatory takeover offer apply if the target company is a public joint-stock company (whose shares are listed (traded) on the regulated market), or a private joint-stock company to the extent such company has at least 250 shareholders or more than €4 million of the total equity. The obligation to make the mandatory takeover offer is triggered when the acquirer (acting individually or with persons acting in concert) reaches
one-third of the voting rights in the target company.\textsuperscript{17,18} On the other hand, if the investor is acquiring a minority shareholding, namely a shareholding that does not reach the one-third of the voting rights threshold, then the mandatory takeover offer will not be triggered, and consequently the timeline for the execution of the transaction may be substantially shortened and the costs of the transaction, due to fewer administrative requirements, may be lower.\textsuperscript{19}

According to Article 24 of the Takeover Act, the potential buyer must, prior to making a takeover bid, notify the Slovenian Securities Market Agency, the target’s management and the Slovenian Competition Agency of its intention to make the takeover bid. Within 30 days, and not before the expiry of 10 days after the publication of the intention to make the takeover bid, and in any case after the investor obtains permission to make the takeover bid from the Slovenian Securities Market Agency, the investor needs to publish the takeover bid, which includes the bid itself, the offer document and the prospectus. To obtain the Agency’s permission, the investor needs to fulfil certain conditions set forth in Article 32 of the Takeover Act.\textsuperscript{20} After the expiry of the takeover bid, the acquirer needs to publish the result of the bid, whereby the success of the bid needs to be confirmed by the Securities Market Agency. After the issuance of the Securities Market Agency’s decision announcing the takeover bid as successful, the Central Clearing Corporation then executes all appropriate steps required to enter the (takeover) shares on the offeror’s account of dematerialised securities, with the effect that the offeror becomes the lawful holder of the shares.

Note that certain transactions are also subject to merger control regulations. The Slovenian Prevention of Restriction of Competition Act sets forth two general triggering events, namely legal and economic conditions that trigger the obligation of notification of the transaction (concentration) to the Slovenian Competition Authority. The latter means that the execution of the transaction first must result, or may result, in a concentration (legal condition). Secondly, a concentration must be notified to the Slovenian Competition Protection Agency (CPA) if the following turnover thresholds (economic condition) are met (cumulatively):

\begin{itemize}
  \item[a] in the last financial year, the combined annual turnover in the Slovenian market of the undertakings concerned together with other undertakings within the group exceeded €35 million; and
  \item[b] in the last financial year, the annual turnover in the Slovenian market of the target undertaking together with other undertakings within the group exceeded €1 million
\end{itemize}

\textsuperscript{17} Paragraph 1 of Article 11 of the Takeover Act defines the takeover bid as a ‘public offer made to all holders of the securities to conclude a contract, which, when accepted, shall result in a contract on the acquisition of such securities between the offeror as the buyer and the accepting party as the seller’.

\textsuperscript{18} The takeover bid also needs to be made or renewed by the offeror who, following a successful bid, has acquired 10 per cent of the voting rights, and the obligation to renew a bid shall cease when the offeror, following a successful bid, has acquired at least 75 per cent of all the target company’s shares carrying voting rights.

\textsuperscript{19} In addition to the obligations under the Takeovers Act, any acquisition below and above the takeover threshold is still subject to a requirement to notify the target company of any acquisition of a ‘major shareholding’, these being set at 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, one-third, 50 per cent and 75 per cent of all voting rights in the target company.

\textsuperscript{20} For the purpose of this chapter we explicitly emphasise the investors’ obligation to provide the Securities Market Agency with the proof that the acquirer has deposited at the Central Clearing Corporation the full amount of consideration in cash required for paying of all securities subject of the takeover offer. Instead of cash, the acquirer may also deposit a bank guarantee covering payment of consideration by the offeror.
or, in the case of the formation of a full-function joint venture, the annual turnover in the Slovenian market of at least two of the undertakings concerned together with other undertakings within the group exceeded €1 million.

A concentration has to be notified to the CPA at the latest 30 days after the conclusion of an agreement, announcement of a public bid or an acquisition of control (the time period of 30 days runs from the first of any of these events) or, in the case of a voluntary notification, within 15 days after the CPA requests notification. Pre-notifications are not expressly regulated but are possible in practice. Notification needs to be submitted to the CPA on a standard concentration notification form, which guides the applicant to provide the CPA with all relevant information with regard to the concentration that is being notified.

In addition, certain specific acts prescribe that the acquisition of certain thresholds – qualifying holdings – requires approval of the competent authority, for example, the Bank of Slovenia, the Slovenian Insurance Supervision Agency, the Securities Market Agency and the Ministry of Culture. In particular, such approvals for the acquisition of qualifying holdings are seen in sectors such as banking, insurance, finance and media.

V OUTLOOK

According to publicly available information, shareholdings in Unior (one of the largest and most important Slovenian exporters, which operates in four production segments: forged parts, hand tools, machine tools and tourism activities), Nova Ljubljanska banka (the largest Slovenian bank), Gorenjska banka (a bank that recently acquired approximately 9,000 leasing agreements from Addiko Bank) and others will be on sale in 2017, which, together with recent trends related to private equity transactions, suggest that the market will be vibrant and that it will grow. Positive experiences with private equity investors, which were just a few years ago considered as a poorer alternative to traditional strategic buyers, raise our expectations that private equity (especially foreign) investors will be the driving force of the privatisation of state-owned companies, especially considering some news reports that several private equity funds might invest into Slovenia in the near future.

On the other hand, we are witnessing certain adaptations of the Slovenian business environment, which is becoming more and more investor-friendly. In the past, governments of different political orientations have tried to reduce administrative barriers for investors, both national and foreign, and to shape a smart tax environment, which has already been reflected in an increase in investment activities.

We are therefore of the opinion that no significant and material adverse legislative changes are to be expected in the near future, since all stakeholders are aware of the importance of a stable and predictable business environment. While there could be some minor legislative interventions, according to a popular and universally accepted belief, such interventions should aim to strengthen and boost a competitive economy.
I OVERVIEW

i Deal activity

Investments

After a first semester of market slowdown heavily affected by political uncertainty, 2016 was finally closed with deal activity slightly above 2015. In value terms, the preliminary estimates available for 2016 suggest investments for an aggregate amount of approximately €3 billion, a 3 per cent increase compared to 2015. This figure is similar to the activity levels in 2014 (with investments in excess of €3.4 billion), evidencing the continuation of a recovery in PE investments that became evident in late 2013 after years of market downturn.

In 2016, while the number of transactions decreased by approximately 12 per cent (584 transactions as compared to 661 in 2015), the transactions revealed a renewed interest in large deals (international investors closed seven transactions exceeding €100 million, representing approximately half of the total investment value in 2016).

Most investments in 2016 (88 per cent of transactions) involved less than €5 million. ‘Mid-market’ transactions represented 38 per cent of the total investment value in 2016 (approximately €1.13 billion), showing a decrease both in terms of value and number of transactions with respect to 2015 (approximately €1.64 billion in 2015 representing 56 per cent of total investments).

Investments by foreign players increased by 17 per cent in 2016 in terms of value, with approximately €2 billion invested in 62 deals. This represented 66 per cent of the total investment value in 2016 (compared to €1.7 billion or 56 per cent of the total value in 2015).

Domestic sponsors contributed €931 million to investment value (31 per cent of the total) in 2016, which decreased by 24 per cent compared to 2015.

Divestments

Divestments in 2016 decreased by 60 per cent in comparison with 2015, after several years of steadily increasing. Despite low exit activity from 2008 to 2013, this increase began in the second half of 2013 and reached record highs (with a high water mark exceeding €4.7 billion in 2014).

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1 Christian Hoedl is a partner and Diana Linage is a senior associate at Uría Menéndez.
In terms of volume, 252 divestment deals were closed in 2016, representing €1.88 billion in value. This suggests a decrease in the size of exit transactions compared with previous years.

Trade sales to strategic investors were once again the most frequently used divestment method (49 per cent), followed by initial public offerings (IPOs) (18 per cent) and secondary sales to other private equity firms (15 per cent).

Fundraising and sponsors
Fundraising by domestic sponsors reached a total of €2.23 billion in 2016, representing a 51 per cent increase compared to 2015. ASCRI estimates that between €3.5 and €4 billion is available to be invested in Spanish companies.

ii 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 more common for mid-market transactions (due to 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 tend to be less protracted than in previous years, although many of them can still extend far beyond six months. Sellers’ pricing expectations remain high and have in most cases increased compared to 2015 and 2014. '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 exclusivity agreement (with a term of between one and three months, which is often extended) based on an indicative offer, followed by a due diligence phase and the negotiation of a share purchase agreement (SPA) or investment agreement. The financing banks (if any) 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) in many cases 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 amount 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 often combines ‘sweet equity’ and a ‘ratchet’. One traditionally used structure 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 (sociedades anónimas). The advantage of this type of scheme for the management team is that the tax on equity-derived gains obtained upon divestment is lower than income tax on employment or director remuneration. The scheme is usually accompanied by entering into a shareholders’ agreement including drag-along and tag-along rights and ‘good 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 normally an internal rate of return (IRR) of between 15 and 25 per cent or 1.5 to 3 times the money invested by the fund. To improve the tax treatment of ratchets, they 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 reduction of 30 per cent for the purposes of personal income tax. This provides a significant advantage over taxation of ordinary gains. However, the application of this 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 applying 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
Spain

Nonetheless, they must be notified to the Investment Registry for administrative, economic and statistical purposes only. Exceptionally, foreign investments in certain sectors must be assessed separately. These sectors include, inter alia: air transport; radio; minerals and raw materials of strategic importance; mining rights; television; gaming; 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 or investment service companies) requires prior authorisation by the corresponding regulator.

Any transaction involving a concentration exceeding the legal thresholds established by Spanish or European law requires prior notification to the antitrust authorities. Antitrust clearance is required before the transaction can be implemented. Spanish antitrust law requires the appropriate application to be filed at the National Market and Competition Commission (CNMC) if one 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 a 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 in aggregate, a market share of 50 per cent or more in any affected market); or

b) The combined aggregate turnover in Spain of all of the undertakings during the previous financial year exceeds €240 million, provided that at least two of the undertakings has an aggregate 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 intra-group turnover). Portfolio companies are deemed to be 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.

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 at least to 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.

In the context of listed companies, control of a listed target is deemed to exist where a person or entity, or a group of persons or entities 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 after the acquisition) a majority of the target’s board of directors. In these cases, control may be acquired either by 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 with at least 5 per cent of the shares (whether individually or aggregately) (3 per cent for listed companies) may require the board of directors to 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 last 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 connected to items on the agenda of a general meeting or submit any questions in writing. The board 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, it cannot be denied if it is 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 shareholder to demand compliance and seek indemnification. Nonetheless, with certain exceptions, it is not grounds to invalidate the shareholders’ resolutions. Likewise, shareholders will be liable for any damages caused by misuse of the information requested or 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 made by a general meeting or the board of directors that are contrary to the 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 more 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 meeting is limited under the SCL. All shareholders can challenge resolutions that are contrary to public policy.

Finally, shareholders holding the minimum percentage to call a general meeting may bring a derivative claim on behalf of the company against any director.

Non-resident sponsors

Transaction structures for foreign PE investments are usually driven by tax factors, in particular 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, which favours direct investments 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.

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. The duty of loyalty
comprises a wide range of duties including, *inter alia*, those regarding conflicts of interest, confidentiality, freedom of judgment and independence from instructions of, or connected 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 the authorisation to be approved by 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 these 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 the right of minority shareholders to exit the company if no dividends (equal to at least one-third of the operating profits legally distributable) are distributed five years after its incorporation. The courts have also upheld the 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 the 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 2016, representing almost half of the total invested value of the year and a significant increase in comparison with 2015. The service sector was most sought-after by investors, followed by IT products, consumer products and healthcare. Noteworthy deals were mostly sponsored by international private equity funds including, for example: Cinven’s acquisition of the real estate appraiser Tinsa, Tasaciones Inmobiliarias and (jointly with Canada Pension Plan Investment Board) the global accommodation platform Hotelbeds; Providence’s acquisition of a significant stake in the mobile operator MásMovil and Yoigo; and Apax Partners’ acquisition of Invent Farma (a company developing, manufacturing and marketing generic drugs).

Mid-market activity was also intense in 2016, with many important transactions sponsored either by international private equity funds or by domestic sponsors. By way of example, the Iberian private equity fund Magnum Capital acquired a majority stake in the silicone products manufacturer Itasa. PAI Partners closed the acquisition of SARquavitae (a leading operator of nursing homes for the elderly) through one of its portfolio companies. Carlyle Group acquired a majority stake in Cupa Group, a Spain-based company producing and distributing natural slate and stone product for roofing and other applications. The Spanish private equity firm Nazca Capital acquired a 75 per cent stake in Caiba, a designer and manufacturer of PET preforms and containers.

**Minority investments**

Private equity funds continue to be prepared to acquire minority stakes in Spanish companies controlled by strategic shareholders, management teams or other private equity sponsors.
Notable transactions in 2016 included ProA Capital’s acquisition of a 30 per cent stake in Grupo VIPS from Goldman Sachs, Nazca Capital’s acquisition of a minority stake in Distribuciones Juan Luna (a specialised supplier of processed food) and Corpfin Capital’s investment in Arenal (Spanish owner of cosmetic stores).

**Expansion investments**

Private equity funds continue to contribute equity to finance the expansion of Spanish businesses. During 2016, several international and domestic private equity firms invested in Spanish companies to support their future growth, development and international expansion. For example, the British private equity firm Charme Capital Partners invested in Ingenomix (a Spanish developer of fertility tests) and the Japanese conglomerate Rakuten invested in the Spanish on-demand car service company Cabify. The international sponsor Kennet Partners, together with Nauta Capital, led a round of investment in Spain-based ABA English, an online English language academy.

**Distressed investments**

2016 saw fewer transactions involving distressed assets in comparison to previous years. This notwithstanding, there were some examples of distressed investments during the year, both involving real estate assets and other industries.

SAREB (Spain’s management entity for impaired real estate assets transferred by nationalised and other state-aided banks) made various divestments in 2016. This included selling Goldman Sachs a non-performing loan portfolio backed by residential assets across Spain. SAREB is expected to continue divesting assets in the coming years through direct sales and banking asset funds (BAFs) (insolvency remote, segregated pools of assets).

In the retail industry, according to public sources, in 2016 the Spanish private equity fund Oquendo acquired a minority stake in restaurant chain operator Grupo Comess (the owner of food chain Tabernas Lizarrán) in a transaction that also involved a reorganisation of the group debt.

**Exits**

In 2016 the Spanish sponsor Corpfin Capital sold its stake in Ingesport (manager of sport and wellness centres under public concessions) to the Spanish private equity firm Torreal and insurer Mutua Madrileña. Spanish private equity firm Nazca Capital divested from Agromillora (supplier of genetically advanced plants) and Inmoncology to the Bahrain firm, Investcorp, and the Australian group, Genesis Care, respectively. Magnum Capital sold a majority stake in engineering services company Eptisa to the Chinese group JSTI.

IPOs had significant relevance in the Spanish market in 2016, fostered by improving stock market conditions. The IPO of Telepizza and Parques Reunidos during 2016 are examples of these types of divestments.

**ii Financing**

The availability of acquisition financing in Spain has increased (in terms of EBITDA multiples financed by the banks) with respect to previous years, although the volume of domestic banking activity still remains below pre-crisis levels. Spanish borrowers now 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 better financing terms to maintain their market share.

Financing terms and conditions offered to sponsors vary depending on the type of financing products, although the interest rates offered by the banks decreased during 2016. In fact, a number of deals that were largely equity financed from 2008 to 2013 were leveraged through recaps in 2014, 2015 and 2016. Banks also seem to be better prepared than before to refinance investments that PE funds had hoped to reimburse upon their divestment long before the agreed maturity date.

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 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. 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 continue to be 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 vendors’ liability.

Although the use of warranty and indemnity insurance in acquisition deals remains rare in Spain, we have seen a significant increase in their utilisation in recent years (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 CNMV (the Spanish Securities Regulator). 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 introduces a new type of private equity fund that invests more than 75 per cent of its assets in small and medium-sized enterprises (SMEs). The law reinforces: reporting obligations; the mechanisms to monitor and prevent conflicts of interest; and the rules on the approval of remuneration and incentive policies. It also imposes restrictions on asset stripping and the requirement to designate depositaries. In addition, the law grants legal recognition to European venture capital funds and European social entrepreneurship funds created by EU Regulations 345/2013 and 346/2013, respectively.

Finally, the law addresses 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 personal and corporate income taxes (CIT) and the tax on non-resident entities entered into force in 2015 and had a significant impact on private equity transactions. Positive developments regarding CIT include the reduction of the tax rate to 25 per cent (as of 2016) and the exemption of capital gains under certain circumstances.

On the contrary, leveraged buyout (LBO) structuring has become more 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 the debt pushdown (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 every year. In addition, goodwill resulting from a merger is no longer tax-deductible. The tax authorities and courts have also denied that the merger between the acquisition vehicle and the target company is eligible for the special restructuring tax regime on the basis that the merger is tax driven and does not pursue valid business reasons.

iii Other legislative changes

The SCL was amended by Law 31/2014 to improve the corporate governance of Spanish companies (see Section II, supra).

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\(^3\) Directive 2011/61/EU on Alternative Investment Funds Managers.
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 the 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 persons and entities that are to 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.

Finally, the Spanish Criminal Code was amended in 2015 and significant changes to the criminal liability of legal persons and compliance standards were introduced.

V OUTLOOK

Private equity activity rebounded in 2014, 2015 and 2016, with investments in the region of €3.4, €2.9 and €3 billion, respectively. Most private equity sponsors seem to expect this trend to continue in the future.

Spain continues to face a number of difficulties in 2017, mainly related to the global economy and domestic macroeconomic imbalances, including high unemployment and public and private debt. The private equity industry itself is facing a number of challenges, including competition by strategic buyers and family offices (mainly from Latin America) and pressure on tax structuring and carried interest.

Nevertheless, there are reasons to be optimistic about the private equity industry. 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 be a good opportunity 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

2016 developed into a strong year for M&A transactions: The number of transactions with Swiss involvement rose by 3.4 per cent compared to the previous year, from 350 to 362 deals. The transaction volume grew by US$34.1 billion, or 40 per cent, over the previous year.

This development is largely attributable to several relevant deals with Chinese involvement. With a traded volume of US$7.5 billion, the acquisition of MultiPlan Inc, a provider of healthcare cost-management services by PE firm Hellman & Friedman, was the top deal of 2016.

The transaction landscape in 2016 was mainly dominated by two countries: China and the US. The biggest Swiss M&A transaction was the US$43.3 billion acquisition of Syngenta by China National Chemical Corporation. This is the largest outbound Chinese acquisition ever undertaken. In October 2016, the review of the acquisition by the European Commission entered Phase II. The US, meanwhile, dominated outbound activities through deals such as the US$5.5 billion acquisition of Capsugel Inc by Lonza Group Ltd.

Despite the uncertainty triggered by major political events such as Brexit and the US presidential election, and a still-strong Swiss Franc, the Swiss economy remains in a good position overall, and the country’s market players are highly active in the international M&A market. Moreover, the Swiss PE sector profited in 2016 from low interest rates and generous borrowing conditions, which led to an above-average relevant deal activity. The total of reported PE deals with Swiss involvement amounted to 86 deals, which corresponds to an increase of 13 per cent compared to 2015. The reported PE deal value increased by 2 per cent to US$30.6 billion.

The acquisition of MultiPlan Inc for US$7.5 billion by Hellman & Friedman and Leonard Green & Partners was the largest PE transaction in 2016 with Swiss involvement and was announced in May 2016.
Successful exits by PE funds reported in 2015 include the following transactions:

a. Kohlberg Kravis Roberts sold Capsugel Inc to Lonza Group for US$5.5 billion;

b. Eurazeo SA and Bridgepoint Advisers sold Foncia Group SA to, *inter alia*, Partner Group Holding;

c. Apax Partners LLP acquired the remaining stake in European medical diagnostics leader Unilabs from Nordic Capital and Apax Partners France; and

d. EQT Partners AB won the bid for the Swiss travel services company Kuoni Reisen Holding Ltd7 with a US$1.4 billion offer.

2016 registered five IPOs compared to 2015, which saw three IPOs, and 2014, with six IPOs. Hence there was an increase in IPOs in 2016. However, the number is still much lower compared to the 10 IPOs observed in 2007.

ii Operation of the market

Save as otherwise provided for in the articles of a company and unless a Swiss company (in the form of a corporation) is listed on a Swiss or foreign stock exchange, the board of directors has sole but reasonable discretion in, and is responsible for, setting up the remuneration of its members and the remuneration of the executives of the company. In practice, often the shareholders’ agreement among the main shareholders provides for the key elements of the management equity incentive scheme to be implemented by the board, on the one hand to fix the size of the scheme and thus the maximum dilution to be suffered by the shareholders, and on the other to ensure the alignment of the interests of the shareholders and the board as well as the management.

Stock option plans are the most common management incentive schemes. However, in some cases stock plans with vesting periods or reversed stock plans with call options for the benefit of the company in bad-leaver cases are also used.

With respect to board and management compensation – including equity incentive arrangements – of Swiss companies that are listed on a Swiss or foreign stock exchange, the Swiss Federal Council adopted, effective as of 1 January 2014, the Ordinance against Excessive Compensation with respect to Listed Stock Corporations (OaEC), providing for enhanced corporate governance rules and control over shareholders regarding the remuneration of board members and executives of companies. In particular, any remuneration of the board of directors or the management is subject to (annual) approval of the shareholders’ meeting.

The OaEC provides in principle for three types of compensation models applicable to compensation for board members, executive management and the advisory board, if any: the compensation is to be approved either on a prospective basis or a retrospective basis, or under a combination of these two models, while the model chosen for the board of directors may differ from the model applicable to the executive management. Looking at the compensation models adopted by Swiss-listed issuers, most companies have opted for an exclusively prospective compensation model (i.e., a model where the general meeting approves both the fixed and variable compensation for both the board and the executive management in advance.8 A limited number of issuers – mainly issuers with a controlling shareholder – have

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7 Alexander Vogel and Stephanie Maurer: Valuation of privileged voting shares in a public offer, ILO Corporate Finance/M&A.

opted for a combined model with prospective and retroactive elements (i.e., models where the fixed compensation is approved in advance and the variable compensation retroactively). Models with a purely retroactive approval have not been implemented.9

It is important to mention that the compensation to be approved by the shareholders’ meeting encompasses all types of compensation that the board or the members of the executive management receive, whether directly or indirectly (i.e., also any compensation for activities in entities that are directly or indirectly controlled by the issuer, e.g., in the event that the management of the issuer is formally employed by a subsidiary, irrespective of whether such subsidiary is domiciled in Switzerland or abroad). In addition to the mandatory vote by the shareholders on compensation, the OaEC provides for the preparation of a remuneration report by the board that must disclose all compensation awarded by the issuer, directly or indirectly.

Furthermore, the OaEC restricts certain types of compensation to the executive management and the board. In particular, sign-on bonuses (‘golden handshakes’) and severance payments (‘golden parachutes’) are disallowed, to the extent not owed to a leaving executive, for a notice period or fixed-term employment agreement not exceeding 12 months.

However, it should be noted that it is still allowable to reimburse an executive for compliance with a post-contractual non-compete obligation, which may have similar effects as a ‘golden parachute’. Similarly, sign-on bonuses will continue to be valid as long as they compensate, for example, for the forfeiture of non-vested interests in share and option plans of the former employer.10

PE transactions in Switzerland not involving a public company do not have timing considerations that differ from any other private Swiss M&A transaction, such as merger control notification requirements or other governmental approvals for certain regulated industries, in particular banks.

For public to private transactions, however, timing is provided by the Ordinance on Financial Market Infrastructure and Market Conduct in Securities and Derivatives Trading (FMIA), pertaining ordinances – in particular the takeover ordinance – and by the takeover board. The prospectus pertaining to the offer shall be published within six weeks from the pre-announcement (if any) of the envisaged public takeover. Following a period of 10 trading days, the offer period can be fixed anywhere between 20 to 40 trading days following the 10 trading-day cooling-off period. After the announcement of the interim result, the acceptance period must be reopened for another 10 trading days. In the case of a competing offer, the offering periods are prolonged by the takeover board to allow the shareholders an effective choice between the two offers.

A squeeze-out can be envisaged if the bidder has obtained 98 per cent of all votes within three months of the end of the acceptance period after the public offer, and at the price of the public offer. If the 98 per cent threshold under the FMIA is not met, but the bidder holds 90 per cent or more of the shares and the voting rights of the target company, the bidder may effect a squeeze-out merger in accordance with and within the timeline provided for in the Swiss Merger Act.

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9 Pursuant to the Ethos Study, only 28 per cent of the companies have implemented a retrospective vote (at the end of the financial year) on the variable remuneration.
10 Alexander Vogel and Samuel Ljubicic, Relevance of Minder Initiative to M&A transactions, ILO Corporate Finance/M&A.
II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Generally, investments made in Switzerland by PE firms are not subject to any particular barriers or restrictions, save for particular key sectors, such as banks. An acquisition of controlling interest made in Switzerland is also subject to competition law or antitrust clearance pursuant to the Swiss Cartel Act. Planned concentrations are subject to pre-closing control by the Swiss Competition Commission if, in the year preceding the concentration, the undertakings involved generated a joint aggregate worldwide turnover of at least 2 billion Swiss francs (or an aggregate turnover of at least 500 million Swiss francs in Switzerland); and at least two of the entities involved generated an individual turnover of at least 100 million Swiss francs in Switzerland.11

The acquisition of a controlling interest or a minority interest in target companies often includes the conclusion of a shareholders’ agreement between the buyer and the seller. Further, a standard acquisition process usually involves the signing of a set of preliminary agreements, such as a letter of intent, an exclusivity agreement and a non-disclosure agreement. Save if explicitly provided for in the letter of intent, provisions of the letter of intent are normally not binding. Letters of intent merely create an obligation to negotiate in good faith, and include the obligation to inform the counterpart of any important matters. A breach of the duty to inform the counterpart may result in damage claims of the other party. Exclusivity agreements are binding and enforceable, and specific performance might be requested.12

Depending on the financial needs and life cycle of the target company, the transaction structure might be different. If the target company is looking for new capital to fund its operations, the PE investment is often effected by way of a capital increase on the level of the target company. In such case, the PE company usually sets up a special investment vehicle (financed by the investors and often leveraged with debt raised from banks), which will act as a shareholder subscribing the new shares in the target company, or the investors will be allowed to act directly as new shareholders of the target company and subscribe the new shares themselves. In these cases, the transaction is usually based on an investment and subscription agreement entered into by the new shareholder and the target company. Further, the investor and new shareholder often have an interest that not only the target company but also existing (majority) shareholders become party to such investment agreement in order to secure potential warranty claims of the investor and new shareholder, which may less enforceable, if at all, if only given by the target company. To carry out the capital increase, the shareholders’ meeting and the board of directors of the target company will have to take the necessary corporate resolutions, which will have to be registered in the competent commercial register.

If there is no obvious financial cash need of the target company, but the PE investment aims to seek to generate operational improvements to increase the value of the company, which shall be realised through exiting the deal after the holding period, the transaction may also be structured by a simple share deal. In such case, the main acquisition document

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11 Alexander Vogel and Samuel Ljubicic, Mergers and Acquisitions Report 2015, IFLR.
for Swiss deals is the share purchase agreement. The share purchase agreement is generally governed by Swiss law, but may be subject to foreign law if so required by a party. In such case, provisions of Swiss public policy provisions are nonetheless applicable and fully enforceable.

The Swiss Code of Obligations provides for special representations and warranties and certain guarantees automatically applicable to the object of a sale performed under Swiss law (i.e., the shares themselves, as opposed to the underlying business of the target). The buyer of the majority or minority stake therefore has an interest in ensuring that the share purchase agreement provides for extended representations and warranties with regard to all aspects relating to the assets, liabilities and agreements as well as the business of the target company. In the case of a breach of a warranty under the share purchase agreement, the buyer is typically allowed to claim damages for the breach. Such right may be preceded by the right of the other party to remedy the breach itself on behalf, and at the cost, of the counterparty. The buyer is sometimes allowed to reduce the purchase price. Swiss law also provides for a statutory right to rescind the purchase agreement in the event of a severe breach or a fundamental error, duress or fraud, but these rights are often contractually limited or excluded – to the extent permitted – by the parties. The purchase agreement usually provides that the right to take legal action based on a breach of representations and warranties by a counterpart is time barred within 12 to 36 months after the completion of the share purchase agreement. However, if a controlling or minority interest is sold by a PE company, the purchase agreement very often provides for only very limited, fundamental representations and warranties, and such claims are usually time barred after six to 12 months, while any claims the buyer may have against the PE seller are limited to a certain position of the purchase price, which is secured with an escrow solution.

PE firms generally implement structures considering the following:

a. tax transparency – proceeds generated shall be taxed to the largest extent possible only at the investor level;

b. limitation of liability for the promoters of the investment and the investors;

c. alignment of interests of investors, sponsor and the board or the management; and

d. control of the sponsor over the investment vehicle.

A PE deal involves three different entities: the investors, the investment vehicle and the investment manager (sponsor).

The choice of location for the investment vehicle depends mainly on the tax incentives and framework provided by the jurisdiction where the vehicle is located. The chosen jurisdiction shall, to the maximum extent possible, reduce or limit tax leakages between the target company and the deal investors. Typical structures often involve multi-level acquisition vehicles with Swiss and Luxembourg level companies, especially for acquisition finance structures in Switzerland, benefiting from the double tax treaty between these two countries.

The location of the investment vehicle is also important for the investors, since the distributions made by the investment vehicle to the investors (or their investment vehicles) are subject to taxation. To reduce or limit tax leakage between the distributions of the target and the investors, the investment vehicles used to be based mainly in the Cayman Islands, with Bermuda, Jersey and Guernsey also being used to some extent. Recently, depending on the investor base, a certain preference for onshore structures that provide for a minimum regulatory supervision of the fund managers can be seen. Investment vehicles are mainly organised as limited liability partnerships providing for tax transparency, limitation of
liability for the investors acting as limited partners and control of the investment structure by the promoter as general partner, usually incorporated in the form of an LLC to limit the liability of the promoter.

**ii  Fiduciary duties and liabilities**

In principle, no fiduciary duty is owed by shareholders of a corporation save for a violation of the law or the articles of association of the company. The Swiss Code of Obligations provides that a limitation of the shareholders’ rights in breach of the law or the articles, or for any improper reasons, discrimination against shareholders that is not justified as being in the company’s interests or the withdrawal of the profit orientation of the company without the consent of all shareholders may be considered by Swiss courts to be illegal, even if it has been approved by a proper majority of shareholders. In addition, Swiss case law provides that a majority shareholder may have a fiduciary duty towards the minority shareholders in certain specific cases.

Executives and members of the board of directors of the company have a specific duty of care and duty of loyalty in relation to the company. Such executives or members of the board are liable in relation to the company and shareholders for loss or damages resulting from the breach of such fiduciary duties. The duty of loyalty provides that directors may not act in their own interests when acting as director of the company, and further prohibits directors from competing against the company. The duty of loyalty provides that directors shall act for the company’s interest in the best possible way. To prevent deadlock situations in situations where a conflict of interest exists, since Swiss law is silent on the topic, companies are advised to adopt an internal set of rules providing for ways to deal in such context.

If the board of directors has lawfully delegated the day-to-day business to a third party such as the management, the board is, however, exempt from liability provided that it can show that the management has been carefully selected, instructed and supervised.

There is in principle no fiduciary duty of the directors in relation to third parties. However, the directors may be held liable towards creditors of the company for breaching their duty to file for bankruptcy in a timely manner once the company has used up its equity due to losses (or if other means are not undertaken to remedy such financial status), unless creditors are willing to cover such losses by subordinating loan claims in the amount of such losses.

The vast majority of the exits made in Switzerland are by trade sales, followed by secondary sales and IPOs. When structuring the acquisition of a Swiss target, promoters try to implement provisions allowing the promoter to get rid of convertible instruments and preference shares by providing mandatory conversion upon the occurrence of an exit event. The contractual arrangements in co-investments in Swiss companies generally include share transfer provisions. The goal is to restrict the sale of a stake held by a co-investor in the company to an undesirable transferee during the investment period, but at the same time ensure that the minority shareholders have an obligation to co-sell or have the right to co-sell along with the majority upon an exit event, by implementing tag-along, drag-along and squeeze-out clauses. A PE firm’s ability to exit its investment is therefore very much depending on the terms of the investment documents and especially the shareholders’ agreement.

For an exit by way of an IPO at the SIX Swiss Exchange, certain criteria need to be satisfied, *inter alia*, that the company shall have a certain minimum size. In addition, an
adequate free float of the company’s shares is required (generally, at least 25 per cent of the issuer’s outstanding shares in the same category must be listed and must represent a capitalisation of at least 25 million Swiss francs).

A redemption of shares by a company or a share buy-back programme may also be implemented in a Swiss company, but must follow strict conditions and thus are usually not considered for an exit as they are restricted to 10 per cent of the issued and outstanding capital. Payment of the shares shall be made out of the distributable reserves of the company only (unless the acquired shares are cancelled immediately after the repurchase by way of a formal capital decrease procedure) and the shareholders shall be treated equally.

III YEAR IN REVIEW

i Financing

PE firms in Europe are increasingly using highly leveraged loans with few safeguards for lenders. Issuance of covenant-light loans, which typically have high yields and loose limits on debt levels relative to earnings, is set to exceed last year’s all-time high, according to sources in the industry.

The following debt financing arrangements are usually put in place for acquisition financings: senior (secured) credit facilities; junior (unsecured or junior-secured) credit facilities or mezzanine facilities; and subordinated (non-interest-bearing) shareholder loans.

Leveraged buyouts generally involve senior and junior debt in the form of revolving and term credit facilities provided by commercial lending institutions (banks) on a syndicated or non-syndicated basis. In addition to or instead of junior debt, PE investors typically provide financing in the form of mezzanine debt or subordinated loans, or both.

Collateral is sought at the level of the target company most of the time, but the debt arrangements are likely to be granted to the acquisition company becoming the target’s parent at closing. Upstream collateral and cross-stream collateral are subject to certain restrictions. Essentially, to be valid, such collateral shall be allowed by the articles of association of the target, be in the corporate interest of the target and be at arm’s length as has been reaffirmed by the Supreme Court in a recent decision. Should the granting of the collateral be considered not to be at arm’s length, the collateral would be considered as a hidden distribution to shareholders and would be required to comply with distribution of equity rules. Equity distribution rules provide that the amount so to be collateralised shall be limited to the amount that the target could distribute to its shareholders as a dividend at such time as enforcement is requested. This limitation is sometimes referred to as the ‘free equity limitation’.

Key legal terms for financings

Depending on the type of transaction and the competition among investors, it has become more common for PE investors to tie the commitments for future financing on specific milestones, and to request detailed representations and warranties both from the target company as well as from the existing (founding or managing) shareholders. In addition, provisions relating to anti-dilution, protection and potential exit procedures are often part of well-negotiated financing arrangements. In the case of additional third-party debt financing, attention must be paid to the interplay of the conditions precedent to closing under the various agreements.
No statutory margin requirements apply directly in connection with the credit facilities used for PE transactions. Indirectly, minimum capital requirements for banks may have an impact similar to margin requirements.

In going-private transactions, the offer prospectus shall contain information regarding the financing of the offer, as well as a statement from the auditors that the bidder took all necessary measures so that the financing will be available at closing.

ii  Key terms of recent control transactions

Timing provisions in PE deal agreements are key terms in current times. The circumstances of most transactions call for a separation of signing and closing, and the parties will require each other to fulfil certain conditions before closing. Acquisition agreements will most of the time provide for a long stop date, failing which the agreement will terminate automatically. There is further an increasing use of termination fees in the form of liquidated damages to mitigate the risk that the deal breaks. In public tender offers, the bidder and the target can agree on a break fee, provided that the clause is drafted in a way that does not oblige the shareholders to accept the offer. Break fees must be disclosed in the offer documents. As a general rule, they should not substantially exceed the cost incurred by the bidder in connection with the offer.

When it comes to purchase price terms, PE deals offer a panel of various mechanisms. In the past, ‘locked-box’ mechanisms have been widely used by PE firms for their acquisition deals, especially prior to the last financial crisis. In the outcome of the financial crisis, a different mechanism, employing closing accounts to have more visibility and certainty on the purchase price to be paid at closing, has increasingly been used by PE professionals.

A ‘locked-box’ mechanism provides for price certainty for the seller, and price and time efficiency as it avoids lengthy pricing discussions and high expert fees after completion of the transaction. It is usually used for stand-alone entities in comparison with groups in multiple jurisdictions. The price may not be changed after signing. Therefore, anti-leakage provisions and indemnification provisions are usually included in the acquisition arrangements. These measures will prevent the seller from syphoning funds out of the target prior to closing.

In leveraged recapitalisation deals, the parties will in principle agree on a purchase price that will be adjusted at closing based on interim financial statements. The parameters relevant for the adjustment are balance-oriented and encompass net cash and debt, net working capital or even the entire balance sheet (net equity).13

IV  REGULATORY DEVELOPMENTS

PE transactions – to the extent not related to shares listed on a stock exchange – are not supervised by a regulatory body in Switzerland (save for the applicable competition law supervision), but PE sponsors are subject to a regulatory supervision if performing their activities from Switzerland. In the wake of the Alternative Investment Fund Manager Directive of the European Union, the Swiss regulation changed as from 1 March 2013; since that date, PE sponsors for Swiss and non-Swiss collective investment schemes are subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

FINMA is an institution under public law with its own legal personality. It is responsible for implementing the Financial Market Supervision Act and financial market legislation.

13 Andreas Rötheli and Stephan Erni, Switzerland unlocked, IFLR Private Equity & Venture Capital.
FINMA supervision over PE managers of related (Swiss-based) collective investment schemes is not required to the extent that such sponsors have qualified investors and one of the following conditions is met: the PE sponsor has assets under management (including with leverage) under 100 million Swiss francs; the PE sponsor has assets under management (excluding leverage) of 500 million Swiss francs for closed-end funds with a five-year lock-up period; or the investors and the PE sponsors are part of the same group.

Listed companies and corporations are not subject to supervision when their shares are in registered form.

Swiss PE managers shall be authorised by FINMA to perform their activities prior to engaging in any PE transactions. Such authorisation is subject to the following:

a. the executives of the PE sponsor shall have good reputations and appropriate professional credentials;

b. controlling investors shall have good reputations, and their influence shall not be prejudicial to prudent and safe management (controlling investors are persons or entities owning 10 per cent or more of the capital or voting rights, or who can materially influence the PE sponsor in any other manner);

c. internal rules and organisation allow the performance of the PE sponsor activities in compliance with legal requirements;

d. sufficient financial guarantees are available; and

e. any other legal requirements are met.

In addition to a control of FINMA prior to the authorisation, the PE sponsor is supervised by FINMA throughout the performance of its activities.

To obtain the required licence from FINMA, the PE sponsor of a Swiss collective investment scheme must demonstrate that it fulfils a number of financial requirements (for instance, a fully paid-in share capital of at least 200,000 Swiss francs and compliance with capital adequacy requirements, capped at an amount of 20 million Swiss francs) and personal criteria (in particular a fit and proper test, somewhat similar to the one applicable under Swiss banking regulations).

Swiss PE sponsors are subject to ongoing supervision by FINMA, which benefits from extensive audit and inspection rights as regards regulated entities. The Swiss regulatory regime is based on a ‘dual supervisory regime’, which requires regulated entities to appoint a FINMA-recognised auditor. The task allocated to such auditor is to verify whether the regulated entity complies with all applicable legal, statutory and regulatory requirements. The auditor’s findings are set out in a report, which is delivered both to the regulated entity and to FINMA (the long form report).

V OUTLOOK

Based on a survey of the M&A market in Switzerland, the outlook for the Swiss market in 2017 is very positive, with 93 per cent of the participants believing that it will be a good year with high industry activity.14 In addition, 82 per cent of the participants advise that the

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M&A market will either stay at its current level or moderately increase in 2017. Particularly high activity is expected by market participants in the area of private banking. A high level of M&A activity is also expected in other areas such as the pharmaceuticals, life science (such as the planned takeover of Actelion by Johnson & Johnson) and chemicals sectors.\(^{15}\)

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\(^{15}\) KPMG, Clarity on Mergers & Acquisitions, January 2017.
I OVERVIEW

i Deal activity

The Centre for Management Buy-out Research (CMBOR) reported total UK private equity deal activity for 2016 of £11.9 billion, the lowest level of activity since 2009, and a significant drop from 2015 levels, which saw £21.2 billion of transactions. However, despite this 44 per cent drop in aggregate deal value, the number of UK deals declined by only 6 per cent, from 424 in 2015 to 398 in 2016, showing that an absence of high value deals, rather than reduced volumes, was the primary cause.

There is little doubt that the result of the UK’s referendum in June 2016 on whether to leave the European Union, and the ensuing macroeconomic uncertainty and market volatility, have had a substantial impact on deal activity. Anecdotally, the market was considerably slower in the immediate run-up to the referendum and the two to three-month period afterwards, with most deals being completed in the first and fourth quarters of 2016. This uncertainty also appears to have had an impact on the European market more widely, with CMBOR reporting a decline in European private equity deal activity from €89.7 billion in 2015 to €55.7 billion in 2016. The UK’s contribution to this total remains the largest. However France is only marginally behind the UK with aggregate deal value during 2016 of €11 billion.

It is evident that the downturn in deals was most noticeable at the top end of the market, with the mid-market (broadly comprising deals with values between £25 million and £500 million) remaining fairly consistent. Indeed, this appears to be the trend across Europe, with the number of deals increasing more in the lower value segments (for example, deal volumes in the €10 million to €25 million range increased by 26 per cent from 2015). This is a marked difference from 2015, when we saw large deals helping the total aggregate deal value in the UK reach the highest point since 2007’s high watermark of £42.2 billion.

ii Operation of the market

Management equity incentive arrangements

The structure and terms of managers’ equity incentives is a key consideration for private equity sponsors to ensure maximum alignment of interests and, ideally, value creation for all participants.

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1 Graham Cross and Nathan Pearce are partners at Addleshaw Goddard LLP. The authors would like to acknowledge the contributions made by Alex Dumphy, Chris England and Cara Phillips in the preparation of this chapter.
Equity incentivisation typically takes the form of ‘sweet equity’ shares in the company concerned that are issued at the start of the investment but subject to clawback in leaver situations. This is in contrast to the US, where options that vest over time are more commonplace. While salary and bonuses are also important considerations for managers when looking at their whole reward package, they are typically a relatively small portion of the potential reward that can be earned from the equity component.

The sweet equity shares will often be paired with a ratchet whereby the value of the sweet equity increases disproportionately more than the institutional strip above certain levels of internal rates of return or money multiple hurdles, or both, thereby providing a greater level of reward for managers for a greater-than-expected level of value creation. While it is difficult to generalise, typical sweet equity percentages tend to be in the range of 15 to 25 per cent.

Where managers are also sellers (most commonly on a secondary or tertiary transaction), there will typically be a requirement for them to reinvest (or ‘rollover’) a certain amount of their sale proceeds into the buying vehicle. In contrast to the sweet equity, which is typically issued for a nominal price, this gives the private equity sponsor comfort that the managers have ‘real money’ at stake. While a 50 per cent rollover is not uncommon, we have seen significant variation either side of that amount and, ultimately, this is always a matter of negotiation in the context of the specific deal. A rollover will typically take the form of investing pari passu with the private equity sponsor in the institutional strip and, accordingly, leaver provisions rarely apply to it (albeit some limited leaver type provisions are sometimes included such as a reduction in the interest rate on the loan note coupon for the rollover and typically only for ‘bad’ leavers).

In recent years, the market has tended towards a more consistent and reasonable approach to management incentive terms that is more management-friendly, in particular in respect of transactions in the mid-market. This is due to the combination of a well-developed management advisory market (which results in managers commonly having independent legal and financial advice and therefore ready access to what is market practice) and the tendency in the UK towards tightly managed auction processes (in which relationships with management can be a key determinant to success). Accordingly, private equity sponsors who are new to the UK market may find themselves disadvantaged if they simply replicate their usual ‘house’ position.

In contrast to some jurisdictions, such as the US, where narrow good leaver and wide bad leaver concepts are utilised, it is now fairly common for there to be three classes of leaver in UK transactions. Good leaver concepts (usually defined as death, ill health or retirement, with shares being acquired at market value) and bad leaver concepts (usually defined as resignation or dismissal for gross misconduct, with shares being acquired at the lower of cost and market value) are often defined narrowly, with everything else constituting an intermediate leaver. The intermediate leaver concept is usually paired with a time vesting mechanism whereby, as time elapses up to the date of becoming a leaver, a greater portion of the sweet equity vests and is subject to acquisition at market value, with the balance being unvested and subject to acquisition at the lower of cost and market value.

Equity incentive plans are often structured to take advantage of available government tax reliefs for UK taxpayers. The well-established entrepreneurs’ relief scheme continues to apply and to be an important scheme to utilise as it reduces the capital gains tax rate for managers from 20 to 10 per cent for the first £10 million of lifetime gains (albeit that its terms mean it is usually only available to a few senior managers). However, the more recently
established employee shareholder scheme (whereby no capital gains tax would be payable) has recently undergone revisions that limit the zero-rated gain to £100,000, meaning that it is no longer seen as attractive in practice in a private equity context.

From an administrative perspective, it has long been the practice in the UK that, in management incentive schemes with many participants, the second and third tier participants would not hold their shares directly but, rather, that they would be held by a nominee on their behalf, thereby meaning that on an exit, only the nominee needs to be dealt with. More recently, we have seen a trend towards this being expanded to include the senior management shareholdings as well.

**Standard sale process**

For both large and small deals, competitive and tightly managed auction processes remain commonplace in the UK market. Such processes will often involve the preparation of vendor due diligence reports of one type or another. For example, instead of a full legal vendor due diligence report on which reliance can be given, a seller may instead opt to prepare a shorter-form ‘storybook’ (on which reliance will not be given) that is intended to provide bidders with an overview and education, from a legal perspective, of the business and how it operates, and to guide the bidder through the data room, so that the bidder’s own legal due diligence can be conducted more effectively. This has the advantage for the sellers of being cheaper and quicker to prepare while not necessarily adversely affecting the timetable of the transaction, as bidders will usually wish to conduct their own legal due diligence in any case.

Where the asset is a highly desirable one, it is not unusual to see pre-emptive offers being made prior to the conclusion of the full offer process and the deal being completed within the space of one or two weeks from the submission of such a pre-emptive offer. It follows that such buyers are conducting limited due diligence and entering into sale documentation on largely seller-friendly terms.

In that case, there is unlikely to be sufficient time within which to properly structure and agree the detail of the management equity incentive arrangements. The common approach is therefore to agree a term sheet in sufficient detail to cover the major issues, and for the parties to enter into a legally binding ‘wrapper’ document under which it is agreed that full documentation reflecting the term sheet will be agreed and put in place within a defined subsequent period.

It remains the case that institutional sellers tend not to provide business warranties. In contrast to, say, the US, where escrow structures are commonly used so that all sellers effectively contribute to the giving of business warranties, it remains UK practice that target management only will provide the business warranties. In that case, management’s liability is usually limited to a multiple of salary or a percentage of their cash proceeds, with the buyer arranging warranty and indemnity insurance on top of that so that meaningful protection is obtained. Our own studies have revealed that approximately half of policies are arranged by the buyer and approximately half by the sellers as part of the auction process (but which the buyer then takes out). The market experienced significant growth in 2015 (with the overall number of policies issued rising by between 32 per cent as reported by one broker, Marsh, and 55 per cent as reported by another broker, Howden) but it is currently unclear whether that continued into 2016, as figures are not yet available. Typically, the warranty and indemnity insurance process does not interfere with the overall deal timetable as it can be completed in around three weeks, parallel to the main transaction negotiations. Premiums are typically
between 1 and 2 per cent of the sum insured (but can be less) with average premiums now running at around 1.39 per cent (down from 1.54 per cent in 2015) according to one broker, JLT.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

The UK is, generally speaking, a very open and flexible market within which to invest. While regard should be had to merger filing requirements at both the UK and (for the time being) the EU level, and certain industries have regulatory regimes where further regulatory approval can be required (for example, financial services), the process is open, transparent, generally predictable and trustworthy.

Multiple newco structures are commonplace, the exact form and details of which are usually determined by tax structuring and debt-subordination requirements. The UK’s extensive network of international tax treaties means it is not unusual to see overseas newcos included in such structuring. The market is sophisticated and used to dealing with such structures on both the sell-side and the buy-side.

The UK’s implementation of the OECD’s base erosion and profit shifting project, and in particular the restrictions on deductions for corporate debt (from April 2017, regardless of when the debt was created), will in many cases mean that investee companies do not obtain tax deductions for all their interest costs. This may cause some private equity houses to restructure the way in which their funds invest. The basic rule is that a group’s deductible interest cannot exceed 30 per cent of group EBITDA, but higher deductions are allowed if the group as a whole is more leveraged (ignoring related party debt). Interest restrictions are worked out at the level of a group and then allocated to individual companies, but the rules always allow a group to deduct £2 million of interest costs so smaller deals may be less affected.

The key legal documents in any transaction will be the sale and purchase agreement and the related warranty disclosure letter and, in respect of the investor’s ongoing relationship with management and any other investors, an investment agreement and articles of association of the investee company. As the articles of association are a public document, their content tends to be limited to the essential transfer and corporate governance provisions, although some investors prefer to not even include those, simply relying on their inclusion in the investment agreement instead.

Where management are sellers, there may also be a separate management warranty deed under which they provide the business warranties. While practice does vary to some extent, it is not uncommon for such warranties to only be given on an awareness-only basis, the warranties’ purpose therefore being solely to drive disclosure rather than apportion risk. Where warranty and indemnity insurance is being obtained, note that the market has now developed such that insurers will commonly agree to cover the warranties on an absolute basis (i.e., such as if they were not given on an awareness-only basis). Buyers find this helpful to bridge protection gaps and help them remain competitive in auction processes.

If is usual for a tax covenant to be included in sale agreements, whereby the sellers are liable for pre-completion tax. The main exception to this is in highly competitive auctions where sellers can be successful at using the competitive tension to exclude it and also for
minimal tax warranties to be included. Buyers therefore have to rely on their own tax due
diligence. Again, additional protection in this regard can be included in warranty and
indemnity insurance policies for a small additional premium.

Private equity investments in the UK have traditionally been of a majority or control
nature, with investors occasionally completing minority investments. The market has now
developed such that some investors (for example, Inflexion’s Partnership Capital fund)
actively present themselves as minority investors, giving management teams the opportunity
to hold both management control and majority ownership with the consequent potential
for increased management equity reward. In such cases, the private equity sponsor takes a
light-touch approach to its involvement, ensuring that it has appropriate information, veto,
exit and downside protection rights, but otherwise leaving management to run the company.

ii Fiduciary duties and liabilities

There are a variety of circumstances where a private equity sponsor or its representatives may
need to consider the duties and responsibilities imposed by law, whether as a shareholder, to
the other shareholders and the investee company, or as a director of the investee company, to
that company and its shareholders and (in certain circumstances) its creditors.

**Duties owed by a shareholder**

Becoming a shareholder in a company does not create a fiduciary relationship with the other
shareholder or the company itself. Any duties or obligations that that arise for a private equity
sponsor by virtue of its subscription for shares in a UK company will do so either by virtue of
the articles of association of the company (which creates a statutory contractual relationship
between the shareholders and the company, and which becomes binding on a shareholder
automatically at the point at which it has been registered as a shareholder) or through the
rights and obligations set out in any binding shareholders’ agreement or other contractual
arrangement that the shareholder may enter into.

It is a core principle of English company law that a shareholder of a UK company does
not assume responsibility for the acts of the company, and the ‘corporate veil’ is only rarely
‘pierced’ and in very specific situations.

It is also clear that shareholders do not have a fiduciary relationship with regards to
each other. The transaction documents negotiated as part of any investment should therefore
clearly set out any obligations that the shareholders are to assume regarding each other or
the company, and there is a reasonably well-settled structure for shareholder rights and
obligations in private equity transactions in the United Kingdom.

Therefore, the shareholders are free to undertake their decision making as shareholders
of a company as they see fit. This generally extends to all decision making that is reserved to
the shareholders, whether contractually or by statute. However, there is a key exception to
this principle in that any amendment to the articles of association of the company may only
be made *bona fide* for the benefit of the company as a whole. This has subsequently been
interpreted to mean that it must be for the benefit of the shareholders generally, which has
led to some continuing uncertainty as to whether the approval of a change to the articles that

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3 Lindley MR in *Allen v. Gold Reefs of West Africa Ltd* [1900].
4 See *Greenhalgh v. Arderne Cinemas Limited* [1951].
only benefits a group of shareholders to the detriment of the others is a legitimate exercise by the shareholders of their power to vote at general meetings. While this can arise in many different circumstances, it is most commonly encountered in the private equity context where one shareholder or group of shareholders is seeking to insert or amend a drag along provision to force an exit.

**Duties owed by a director**

The board of directors has overall responsibility for the affairs of a company. Its powers must be exercised in good faith to promote the success of the company for the benefit of its members as a whole, and the company's property must be applied for its specified purposes.

Those duties are owed to the company, and it is therefore the company that may sue the directors for breach of duty or for loss caused if they act outside their powers. In exceptional circumstances, the directors may become liable to the company's shareholders or (on insolvency) its creditors. If they are directly involved in a tort (civil wrongdoing) by the company, they may be liable jointly with the company.

The Companies Act 2006 codified a number of common law fiduciary duties owed by a director to the company as follows:

- **Conflicts of interest:** directors must avoid a situation in which they have or can have an interest that conflicts, or possibly may conflict, with the company's interests. They must not obtain a financial advantage at the company's expense. They must also disclose interests in any proposed or existing transactions or arrangements with the company. In relation to the sponsor's representatives on the board of its investee company, it is therefore important to recognise their diverging interests and ensure these are disclosed or appropriately approved, or both.

- **Duty of care and skill:** directors also have a duty to exercise reasonable care, skill and diligence, judged both by reference to their own qualifications and the standards that may reasonably be expected of a director in their position. This will include having a working knowledge of the company's business affairs. If they are also an employee of the company, their employment contract may impose objective standards of care and skill. The standards of care, skill and diligence apply to all directors, whether executive or non-executive.

- **Statutory duties:** directors are subject to a number of statutory duties and may incur civil or criminal liabilities, or both, for their breach. They may also incur criminal liability if they are responsible for allowing the company to commit certain criminal offences. They may be disqualified from acting as a director if they allow the company to breach competition law.

- **Indemnification:** directors may not be exempted by the company against liability for negligence, breach of duty or breach of trust. Subject to certain exceptions, they can, however, be indemnified by the company against such liability. The company can also purchase directors' and officers' liability insurance.

The above duties apply to all directors, whether executive or non-executive. Importantly, they apply personally to any director who takes office as the nominee of a private equity sponsor. This is in contrast to some other European jurisdictions where there are separate supervisory and management boards with lesser duties for members of the supervisory board.

In addition, many of the obligations on directors apply equally to shadow directors, defined in the Companies Act 2006 as persons in accordance with whose directions or
instructions the directors of a company are accustomed to act. This can include institutional
investors who are able to direct the actions of the board. The expression ‘accustomed to act’
implies a course of conduct rather than isolated incidents, but advice should be taken if in
doubt.

III YEAR IN REVIEW

i Recent deal activity

There were a number of interesting themes and developments over the course of 2016.

The first saw the continued rise of the multi-fund strategy. Both Inflexion and
Livingbridge launched new funds with a focus on growth capital and smaller buyouts
alongside their existing mid-market funds. This perhaps demonstrates a desire by experienced
and successful fund managers in an established market to avoid limiting their scope for
transactions while enabling them to service limited partners who have an appetite for
exposure to different parts of the market.

In addition, it recognises the resurgence of venture capital in the UK as investors
look to tap into the growing investment market for technology and technology-led services,
notably in areas such as financial services, payments and regulatory compliance, but also
across the media and consumer sectors generally. That said, while the volume of megadeals
fell away, there were some notable exceptions, including CVC’s sale of Formula One for a
reported US$8 billion.

Another theme throughout the year was the emergence of a number of smaller first
time funds, typically led by experienced investment managers from established UK buyout
houses, either looking to go it alone or tap into a particular market segment.

At the same time, investor activism has taken hold, with a number of high profile
interventions, predominantly into UK listed companies, as well as the removal of Electra
Partners as the fund manager to the listed UK investor, Electra Private Equity.

Finally, the prevalence of debt and credit funds continues. While the market for
distressed debt instruments in the UK has clearly fallen from its post-crash high, there
remains significant investor appetite for debt-focused transactions, especially as the UK
clearing banks continue to face evermore stringent capital requirements. At the same time,
as noted below, the rise of alternative lenders continues as non-traditional financing becomes
more commonplace, especially in private equity transactions.

ii Financing

Debt finance for private equity transactions in the UK remained buoyant, with traditional
lenders still providing liquidity despite challenges from a regulatory and returns perspective.
Alternative lenders continued to grow market share in 2016 with a number of debt funds
(notably Ares, European Capital, Alcentra, Hayfin, Bluebay and ICG) really consolidating
their positions as ‘go-to’ mid-market lenders on private equity deals. In addition, the likes
of GSO, who are more active in the upper market, are also regularly seen in the mid-market
space.

While the appeal of non-amortising term facilities to sponsors is obvious, investment
committees at debt funds have also shown themselves to be less dogmatic than some
traditional lenders. An example of that is the pre-permitting of recapitalisations to finance
payments to shareholders (usually subject to a cap that opening leverage is not exceeded). It is that flexibility that has driven debt advisory firms and their private equity clients to ensure that in 2016, debt funds maintained their market position in UK deals and grew it in Europe.

It has been interesting to see the traditional lenders respond to the specialist debt fund challenge in the mid-market. The more successful of them have teamed up with insurers and pension funds to create pre-agreed lending clubs. This has ensured that those banks get a seat at the table on leveraged financings and do not lose out due to ticket size. Other traditional lenders have responded by providing attractive pricing, flexible terms and Term Loan B-only structures, while some have had to content themselves with providing the super senior working capital facilities alongside the term facilities. The legal terms in loan agreements and intercreditor documents for super senior facilities are now relatively settled, ensuring that those documentation negotiations do not impact the execution of transactions.

Mezzanine debt remained at a low level in 2016, following a similar trend to 2015. The rising popularity of unitranche and the ability of most borrowers to obtain the levels of leverage they want via this route is continuing to squeeze mezzanine finance further out of the leveraged market.

As has been experienced in previous years, given the fragilities surrounding high yield bonds and the knock-on effect that investor appetite has had, 2016 was another year of peaks and troughs in the high yield market. The issuance of high yield bonds in 2016 fell 13 per cent when compared to 2015; despite this fall, however, leveraged buyout-focused bond deals accounted for almost 6 per cent of the 2016 volume, up from 3.29 per cent in 2015.

Second lien debt in the leveraged market remained at low levels, accounting for less than 5 per cent of the overall leveraged loan market in 2016. The investor base for second lien loans remained unchanged (as has largely been the case for the past decade), with capital largely coming from hedge funds and distressed loan investors occupying the upper end of the market.

While there have not been any great shifts over the year on legal terms, the desire to lend from market participants has invariably led to the continued direction of travel towards increasingly sponsor-friendly documentation. As examples in the mid-market, sponsors should find their documentation:

- no longer contains an interest cover covenant;
- permits equity cure with only 50 per cent of the cure being applied in mandatory prepayment;
- contains a right of pre-emption where pre-event of default the sponsor can acquire the existing lenders’ debt should it be transferred; and
- baskets for disposal, loans, guarantees, etc., that grow with the EBITDA of the investee company.

At the upper end of the market, legal terms remain fiercely pro-sponsor, with negotiations limited and liquidity in the secondary market being the exit route rather than the enforcement of rights under the documentation.

As for the year ahead, we expect a trend towards asset-based lending facilities providing super senior working capital (this is already well established in the US) and for there to be some consolidation of specialist debt funds. What is more difficult to predict is the impact that Brexit will have on leveraged loan financings. However, it is clear that the impact of the vote was not felt to the extent that some had feared in 2016.
iii Key terms of recent control transactions

Certainty and ease of transacting remain important for private equity investors. Locked box pricing structures remain the most popular pricing methodology, with completion accounts mechanisms only being used when there are specific factors necessitating it (such as a long gap between the date of the locked box accounts and completion or a particularly cyclical business). Occasionally, a ‘ticking fee’ will be included in locked box mechanisms to capture part of the cash generated by the business after the locked box accounts date.

Deal conditions tend to be limited to legal or regulatory conditions, with material adverse change clauses remaining relatively uncommon (in contrast to the US, where they are often included and conditions generally tend to be wider). ‘Hell or high water’ clauses in respect of legal and regulatory conditions are relatively uncommon, albeit this is ultimately a matter of negotiation and transaction specifics.

As we have already commented, private equity sponsors generally limit their warranties to those relating to title, albeit that they will seek a full suite of business warranties from non-institutional sellers (who are often prepared to provide them). The concept of full disclosure of the data room on a ‘fair disclosure’ basis is generally accepted, in contrast to the US where disclosures are expected against specific warranties only. As already noted, warranty and indemnity insurance is a key part of the mergers and acquisitions landscape in the UK and often features in private equity transactions, in particular where only management is providing warranties. The number of policies continues to grow, and it is possible to agree protection over and above that provided in the sale agreement itself.

Historically, many UK companies operated defined benefit pension schemes for their employees, so there are still a large number of ongoing and legacy schemes. Since 2005, the Pensions Regulator has had wide powers to require a company (and, in certain circumstances, its shareholders and investors) to contribute to the funding of a defined benefit pension scheme. Private equity investors have become relatively comfortable investing in companies with defined benefit schemes, but a recent case (whereby a private equity investor was made liable towards the pension scheme) has resulted in a renewed focus on the risks. Accordingly, although there should be no cause for alarm in many circumstances, this is an area that can impact on transactions, and it is important to ensure appropriate diligence is conducted and advice obtained on the risks.

iv Exits

As noted above, the number of large exits in the UK in 2016 was limited, as mid-market transactions dominated. However, CVC’s sale of Formula One as well Bain’s £2.2 billion disposal of Brakes Group were the notable exceptions to this.

IV REGULATORY DEVELOPMENTS

i Overview of the current regulatory environment

Where a private equity sponsor carries on activities that are ‘regulated activities’ in the UK and there is no exemption available to it, it will need to be authorised by the UK Financial Conduct Authority (FCA) and, in some cases (for example, where insurance or deposit-taking activities are being carried out), the UK Prudential Regulation Authority (PRA).

Many private equity funds will be alternative investment funds (AIFs). Therefore, many UK private equity sponsors will be regulated as alternative investment fund managers (AIFMs) under the Alternative Investment Fund Managers Directive (AIFMD), and will require authorisation from the FCA as an AIFM with permission to carry on the regulated activity of managing an AIF.

Where private equity fund sponsors provide investment services that amount to the regulated activities of advising on investments, arranging deals in investments, making arrangements with a view to such deals, dealing in investments as an agent and managing investments, they will be regulated as investment firms under the Markets in Financial Instruments Directive (MiFID) and will require authorisation from the FCA to carry out these investment activities. Private equity sponsors may also carry out some MiFID activities as well as being an AIFM.

The activities a private equity sponsor is permitted to undertake as part of its FCA authorisation will determine the ongoing regulatory requirements to which it will be subject and the amount of regulatory capital required.

ii FCA authorisation process

An entity that intends to undertake regulated activities in the UK should submit an authorisation application to the FCA in the prescribed form along with the application fee. The application is fairly detailed, and for this reason many applicants seek assistance and advice from legal advisers and compliance consultants. Among other things, applicants must provide full details about their group structure, operations, business plan and governance framework.

The application process can be quite lengthy. The application itself generally takes some time to prepare, and the FCA then has six months from submission of a complete application and 12 months from submission of an incomplete application to consider it and either approve or reject it.

iii Ongoing obligations

An FCA-authorised firm will be subject to a number of ongoing regulatory requirements. The number and complexity of these requirements will depend to a certain degree on the particular regulated activities being carried out by the FCA-authorised firm. However, all FCA-regulated firms will typically have to ensure they comply with regulatory capital requirements, senior management and staff, systems and controls requirements, financial crime laws (e.g., anti-money laundering rules), conduct of business requirements, and monitoring and reporting requirements.

AIFMD also imposes ongoing obligations on an EU manager of an AIF. Among other things, these include disclosure of certain information to investors and regulators, more detailed rules regarding operations and organisation, the appointment of a depositary (similar to a custodian) to hold fund assets, the adoption of appropriate remuneration policies, specific valuation requirements, restrictions on ‘asset-stripping’, and notification of the acquisition of interests or control in certain companies.

6 Directive 2011/61/EU.
7 Directive 2004/39/EC.
iv  FCA consent to changes in control
Where a private equity sponsor proposes that a fund it manages acquire an interest in a company or group that is or contains an FCA or PRA-authorised firm (for example, a bank or other financial services company), it must consider whether the acquisition will result in it and other entities or persons within the group or ownership chain becoming a ‘controller’ of the FCA or PRA-authorised firm. The relevant threshold for an entity or person becoming a controller upon completion of the transaction will depend upon the activities being undertaken by the FCA or PRA-authorised firm being acquired. For FCA or PRA-authorised firms that are subject to MiFID and certain other EU directives, the relevant threshold for becoming a controller is the acquisition of 10 per cent or more of the share capital or voting rights (held directly or indirectly) in the FCA or PRA-authorised firm and, for other FCA-authorised firms, the relevant threshold increases to 20 or 33 per cent of share capital or voting rights (held directly or indirectly). Control is defined broadly, and extends beyond traditional share capital or voting rights thresholds to include concepts such as ‘significant influence’. Accordingly, assistance and advice from legal advisers and compliance consultants is often sought. The FCA has 60 working days from receipt of the application to either approve or reject it, so it is advisable to consider whether change in control consents are required at an early stage in the deal process.

v  Forthcoming developments

The European Commission’s review of AIFMD
The European Commission is expected to start a review of the application and the scope of AIFMD by 22 July 2017. The Commission is required to analyse the functioning of AIFMD’s rules and the experience acquired in applying them, its impact on investors, AIFs or AIFMs in the EU and in third countries, and the degree to which AIFMD’s objectives have been achieved.

The Commission has the power to propose appropriate amendments to AIFMD as a consequence of this review. The impact of any amendments coming out of the review on UK private equity sponsors may depend on whether the UK has completed its exit from the EU by that time and the arrangements with regard to the single market. Assuming the review is completed and any amendments to AIFMD are made before Brexit, UK private equity sponsors will no doubt be keen to see whether the Commission uses its power to clarify areas of uncertainty that have emerged.

Third-country passport equivalence
AIFMD contemplates that a third-country passport, allowing marketing of a fund in the EU, will be made available to qualifying non-EU managers who opt in to full compliance with AIFMD and submit to the jurisdiction of one of the EU’s regulators. AIFMD provided that the European Securities and Markets Authority (ESMA) would be required to review the marketing regimes two years after AIFMD was implemented, and that the process for extending the marketing passport would only be initiated upon receipt of positive advice from ESMA.

ESMA has assessed a number of non-EU countries (including Australia, Bermuda, Canada, the Cayman Islands, Guernsey, Hong Kong, Japan, Jersey, the Isle of Man,

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8 This is the date set by AIFMD for the review.
Singapore, Switzerland and the United States) to which the passport could be extended, and has given some form of positive assessment in relation to Canada, Guernsey, Japan, Jersey and Switzerland. Now that ESMA has provided some form of positive assessment, it remains to be seen whether the Commission will take the next step and draft a delegated act to activate the third-country passport for these countries.

Since the UK’s vote to exit the EU, the approach of ESMA and the Commission has become of more interest to UK private equity sponsors because, following Brexit, the UK may become a ‘third country’ and may itself need to be assessed for extension of the third-country passport to it.

The implementation of MiFID 2

MiFID is being amended by the revised Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (together, MiFID 2), which will come into force on 3 January 2018. The amendments are wide ranging and will require firms to make some significant changes. Over the next year, UK private equity sponsors that are regulated under MiFID will therefore need to review their policies, procedures, documentation, systems and controls to ensure that they are able to comply with the requirements of MiFID 2 from 3 January 2018. The FCA may also choose to apply the requirements of MiFID 2 to other regulated firms, including private equity sponsors who are regulated under AIFMD. Therefore, UK private equity sponsors that are not regulated under MiFID but are regulated under AIFMD may also be required to apply the requirements of MiFID 2 in some areas.

V OUTLOOK

The political, economic and financial landscape remains dominated by the UK’s decision to leave the European Union, and the details of how this will look for the UK’s business environment after the triggering of Article 50 will inevitably be a key driver of deal activity going forward as investors look to assess and address the impact on their existing portfolio companies, while at the same time looking to exploit the opportunities that will undoubtedly arise. The government’s approach, especially in areas such as the movement of goods and people, the ongoing customs relationship with the remainder of the EU and the regulatory position for the UK’s financial services industry, should each be areas of key focus for investors.

In addition to Brexit, investors will also be faced with a shifting global political outlook in key trading partners, including the new US administration and impending elections in Germany, France and the Netherlands, all of which will have a bearing on the already turbulent macroeconomic landscape.

The continued pressure on sterling will make some UK assets attractive for dollar buyers. However, on a purely domestic level, given the ready availability of leverage and the increasing dry powder held by those investors with a UK investment focus, it seems likely that the activity levels seen in the last quarter of 2016 will continue and, if anything, pick up as the year continues and the UK’s position in the world becomes clearer.
I OVERVIEW

Deal activity

2016 was a solid year for US private equity sponsors. Although the buyout market remained robust, increasing competition from strategic buyers, continued struggles in sponsor-led initial public offerings (IPOs) and a slower fundraising environment led to an overall decrease in both absolute transaction value and number of transactions as compared to 2015 and 2014 – even as both deal activity and value remained well above 2013 levels. While exits were below 2015’s record-setting levels, private equity firms continued to aggressively monetise investments, returning capital to limited partners primarily through sales to strategic buyers and secondary buyouts by other private equity sponsors. Lending to private equity-backed companies increased slightly versus 2015 due in part to a surge in dividend recapitalisations in the fourth quarter of 2016.

Buyouts

Private equity sponsors completed 14 per cent fewer US buyout transactions in 2016 than 2015, although the total amount invested fell by slightly less – 12 per cent – reflecting the market’s continued interest in upper middle-market transactions and mega deals. Private equity firms led several very large buyouts, including: the US$60 billion acquisition of EMC by Silver Lake-backed Dell; the US$6.9 billion take-private of ADT Security Services by Apollo; the US$14.2 billion take-private of Keurig Green Mountain by JAB Holdings; the US$7.5 billion acquisition of MultiPlan by Hellman & Friedman; and the US$7.4 billion acquisition of Veritas Technologies by the Carlyle Group.

Add-on transactions (i.e., acquisitions by private equity portfolio companies) increased their share of US buyouts, accounting for 64 per cent of 2016 transactions, up from a 61 per cent share in 2015.

A continued increase in M&A activity by strategic buyers led to a subdued 2016 market for private equity sponsor-led take-private transactions. While the number and value of those deals increased over 2015’s levels – there were 11 more such take-privates in 2016, and the aggregate value was up 24 per cent – they remained below 2013’s levels.

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1 Paul Anderson is a partner at Kirkland & Ellis LLP. The author thanks Steve Ritchie, Norbert B Knapke II, Deneese Walia Levin and the firm’s research staff for their help in drafting this chapter.
3 Id.
4 Source: MergerMetrics.
Growth equity

2016 saw a sharp increase in US growth equity investments (i.e., purchasing a minority equity stake in a mature firm) by private equity firms, with the total number of deals up nearly 90 per cent from 2015 levels, and the aggregate reported value up almost 62 per cent compared to 2015.\(^5\)

Exits

US private equity firms took advantage of a stable M&A market to harvest investments in 2016. Active strategic buyers and continued sponsor-to-sponsor buyout activity made 2016 the second-best year for M&A exits ever by deal value, coming off of 2015’s record numbers by 22 per cent in deal value and 18 per cent by deal count.\(^6\) The 2016 US market for private equity exits exceeded 2014’s deal value total by 6 per cent, but fell off by 13 per cent when measured by deal count.\(^7\)

The M&A market was strong enough to give firms opportunities to exit several recent mega deals. For example, in June, Starr Investments sold MultiPlan (originally acquired in 2014) to Hellman & Friedman for US$7.5 billion, while in September, Blackstone sold Strategic Hotels & Resorts to Anbang Insurance Group for US$6.5 billion just 10 months after taking it private for US$3.9 billion. Other firms harvested older investments, as when TPG and Leonard Green sold Petco (acquired in 2006) sold Petco (acquired in 2006) to CVC Partners and Canada Pension Plan Investment Board for a reported US$4.6 billion, and Vestar sold Sun Products (acquired in 2008) to Henkel Consumer Goods for US$3.6 billion.

The overall IPO market continued to be very weak, resulting in another slow year for PE-backed IPOs: only 32 PE-backed companies went public in 2016 – the lowest number since 2009 – compared to 39 in 2015, 75 in 2014 and 67 in 2013.\(^8\) Notable 2016 PE-backed IPOs include foodservice distribution company US Foods, insurance and financial services company Athene Holdings and home rental company Invitation Homes.\(^9\)

In 2016, secondary buyouts (i.e., sponsor-to-sponsor transactions) continued to grab an increasing share of the total number of M&A exits (from 44 per cent in 2015 to 47 per cent in 2016), but continued to fall as a share of the total value of M&A exits.\(^10\)

Looking ahead, the market for IPOs, corporate acquisitions and secondary buyouts will continue to be important for private equity firms looking to liquidate their still-large inventory of portfolio companies. However, private equity firms have made significant progress in reducing their inventory of portfolio companies acquired before 2008.

Financing

The overall volume of US debt financing increased slightly in 2016 when compared with 2015, but M&A lending contracted slightly versus 2015 levels. According to Thomson Reuters, leveraged lending in 2016 increased slightly – to US$1.1 trillion – over 2015 levels, but US M&A financing fell by 12 per cent;\(^11\) as a result, M&A comprised a smaller share –

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5 Source: Pitchbook data.
6 Source: Pitchbook (see footnote 2).
7 Id.
8 Source: Pitchbook data.
9 Source: IPOVitalSigns.com data.
10 Source: Pitchbook (see footnote 2).
48 per cent – of the total market, versus 61 per cent in 2015. However, lending to private equity sponsors (for all purposes, including M&A, refinancing and dividend recaps) increased 26 per cent, driven in part by an increase in lending to portfolio companies to finance dividends or stock repurchases (particularly in the fourth quarter of 2016). High-yield bond issuances continued to fall – about 11 per cent from 2015’s levels – as pricing pressure continued to suppress the market’s appetite for new issuances. ‘Covenant-lite’ loans (i.e., loans with minimal financial maintenance covenants) continued to be popular, comprising 73 per cent of the 2016 market, with the aggregate principal amount of new covenant-lite loans increasing by nearly 38 per cent over 2015 levels.

The 2016 market continued to see decreases in leverage levels and increases in equity contribution amounts. The average debt multiple for large corporate leveraged buyouts (defined as borrowers with more than US$50 million in earnings before interest, taxes, depreciation and amortisation (EBITDA)) shrank slightly to 5.5 times EBITDA in 2016 from 5.7 times EBITDA in 2015, while the average debt multiple for middle-market LBOs (borrowers with less than US$50 million EBITDA) also decreased from to 5.4 times EBITDA in 2015 to 5.2 times EBITDA in 2016. At the same time, the average amount of sponsors’ equity contributions increased from 39 per cent of total capitalisation in 2015 to 42 per cent in for the first three quarters of 2016.

In late 2013, the Board of Governors of the Federal Reserve System (Fed), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), the main US banking regulators, issued guidance intended to improve leveraged lending underwriting standards among financial institutions under their jurisdiction and to reduce overall systemic risk believed to be caused by weak leveraged lending practices. After reviewing the financial institutions’ compliance with the original guidelines, in 2014 the agencies published additional guidance indicating that they would initiate monthly monitoring focusing on four leveraged lending parameters:

- the borrower’s leverage, with concerns raised by total debt-to-EBITDA ratios in excess of six times;
- whether the borrower has the ability to repay its debt over the medium term (e.g., five to seven years) from free cash flow;
- whether the loan agreements contain adequate covenant protections; and
- whether the loan agreements allow for the material dilution, sale or exchange of collateral or cash flow without lender approval.

Leverage remains below levels seen in the past couple of years as regulated lenders continued to be wary of leveraged loans that run afoul of leveraged lending guidance, particularly where leverage on loans exceeds 6 x EBITDA.

12 Source: S&P/Capital IQ, LCD’s Leveraged Lending Review – 4Q16.
13 Id.
14 Source: Thomson Reuters (see footnote 17).
15 Source: S&P/Capital IQ (see footnote 18).
16 Id.
17 Source: Thomson Reuters (see footnote 17).
18 The Fed generally oversees the US operations of foreign banks (e.g., Banco Santander, Barclays and UBS) and US bank holding companies (e.g., Citigroup and Goldman Sachs).
19 The OCC generally regulates national banks such as Bank of America, JPMorgan Chase and Wells Fargo.
20 The FDIC (among other things) insures deposits at US depository banks.
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:

a the fiduciary obligations of the target’s board of directors as defined by the laws of the target’s state of incorporation (most frequently, Delaware);

b financing risks; and

c 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.\(^\text{21}\) Revlon requires a contextually specific application of the board’s normal duties of care and loyalty designed to ensure that it conducts a process to seek and attain the best value reasonably available to the target’s stockholders. There is no single, court-prescribed course of action for a board to follow (e.g., conducting a pre-signing auction for the target or always using a special committee of disinterested directors to negotiate with a suitor). However, certain conventions – such as fiduciary outs and limits on termination fees and other deal protections – have arisen in response to guidance from Delaware courts to balance the target board’s obligation under Revlon and the bidder’s desire to obtain deal certainty. For example, many deals feature a ‘go-shop’ exception to a target’s customary ‘no-shop’ covenant.\(^\text{22}\) 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

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\(^{21}\) 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.

\(^{22}\) 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 target stockholders.
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.23

Parties to a US leveraged take-private must contend with the risk that debt financing may not be available at closing. Unlike 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) is neither required nor available in the US, and financing commitment letters, no matter how ‘tight’ (i.e., lacking in pre-conditions) cannot be specifically enforced even if the providers of such 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 of 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.24

Parties to a sponsor-led take-private transaction add yet another level of complexity when they choose to proceed via a two-step tender offer (rather than a one-step merger). In a tender offer, the sponsor offers to purchase the shares of the target directly from the stockholders, obviating the need – at least in the initial step – for a stockholder vote. The sponsor’s obligation to complete the tender offer is typically conditioned upon stockholders tendering more than 50 per cent of the outstanding shares. If this ‘minimum tender’ condition is satisfied, the sponsor must acquire all untendered shares in a ‘back-end’ merger, the terms of which are set out in a merger agreement executed by the target and buyer on the day they announce the tender offer. Depending on the circumstances of the deal, including the target’s state of incorporation, the ‘back-end’ merger can be completed immediately after the closing of the tender offer; otherwise the buyer must engage in a long (three to four-month) and expensive proxy solicitation process and hold a target stockholders’ meeting before it can complete the back-end merger.

Failure to acquire all of the outstanding stock on the same day the tender offer closes makes it much more difficult to use debt financing due to 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

23 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.

24 Not all deals follow this model. In some deals, sponsors have assumed all of 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).
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 of 2013, Section 251(h) eliminates, subject to certain conditions, the requirement for stockholder approval of a back-end merger after a tender offer for a listed company or one with more than 2,000 stockholders of record if the buyer acquires more than the number of shares required to approve a merger (typically a bare majority, but it could be more if the target’s certificate of incorporation so requires) but less than the 90 per cent threshold for a short-form merger.

Section 251(h) is an important and useful innovation, as it allows the buyer to acquire all of the outstanding shares and the non-tendering stockholders to receive the merger consideration without the lost time and expense of a three to four-month proxy solicitation process. Furthermore, in June of 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

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25 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.

26 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.
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. In 2015, 84 per cent of public company deals valued over US$100 million faced at least one shareholder lawsuit.27 These lawsuits, often filed within hours of a transaction’s public announcement, have often been 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, Delaware courts have recently soured on these ‘disclosure-only’ settlements,28 with the plaintiff’s bar taking note of this trend: in the first six months of 2016, just 64 per cent of public company deals valued over US$100 million have been challenged.29 With the disfavour of disclosure-only settlements continuing apace in Delaware courts, it appears likely that the plaintiff’s bar will focus on more fertile grounds in the years to come.

**Deal litigation**

Several key 2016 decisions suggest that one such area of focus going forward may be appraisal actions.30 Subject to certain requirements,31 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 have given substantial weight to the merger price in determining the true ‘fair market value’ of a stockholder’s shares.32 Several 2016 Delaware cases, however, 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.33 These judicially derived values can vary substantially from the merger price. Interestingly enough, these recent cases suggest that Delaware courts are more apt to discount the deal price and give more weight to their own analysis in instances where the acquirer is a private equity sponsor.34 It remains to be seen whether 2017 will bring continued independent judicial

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27 Source: Cornerstone Research, Shareholder Litigation Involving Acquisitions of Public Companies, August 2016.

28 See, In re Riverbed Technology, Inc. (Del. Ch. 2015); In re Aruba Networks, Inc. Stockholder Litig. (Del. Ch. 2015); and In re Trulia, Inc. Stockholder Litig. (Del. Ch. 2016).

29 Source: Cornerstone Research (see footnote 35).

30 See, In re Appraisal of Dell Inc. (Del Ch. 2016); In re Appraisal of DFC Global Corp. (Del. Ch. 2016); and John Douglas Dunmire v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc. (Del. Ch. 2016).

31 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.


33 Id.

34 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.
determinations of ‘fair market value’ in appraisal actions or a return to reliance on deal price as the primary indicator of value, and whether we will continue to see a distinction between cases involving a private equity acquirer and a strategic acquirer.

**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.35

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 likely will adversely affect the competitiveness of a bid, particularly in a larger deal. Indeed, in the current market many private-target acquisition agreements (a clear majority in larger deals) contain the same conditional specific performance and reverse break fee mechanism now common in take-private transactions.

The US buyout market has also seen continued growth in the use of commercial insurance policies intended to protect buyers or sellers (or both) against various transaction-related risks, such as breaches of representations and warranties. These insurance products often allow parties to bypass difficult negotiation over post-closing indemnification by shifting specified transaction risks to a sophisticated third party in the business of taking such risks. An increasing number of private equity firms have successfully used M&A insurance to either make their bids more attractive to sellers or limit their post-closing liabilities when exiting an investment.

**Management equity**

Management equity practices vary across US private equity firms, but certain themes are common:

- executives with sufficient net worth are expected to invest side-by-side with the sponsor to ensure they have sufficient ‘skin in the game’;
- management equity entitles the holder only to modest stockholder rights – in some cases, only the right to be paid in connection with a distribution or liquidation;
- holders of management equity get liquidity when and to the same extent that the sponsor gets liquidity; and
- incentive equity (and at times part or all of management’s co-invested equity as well) is subject to vesting, whether upon passage of time, achievement of various performance goals, or a combination of the two.

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35 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.
The size of the management incentive equity pool generally ranges from 5 to 15 per cent, 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 US 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 (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 US (CFIUS) of an investment by a non-US investor in a US target, if the investment threatens to impair national security; and

36 The tax implications of any private equity transaction are tremendously complex. For a thorough discussion of such issues, see generally Ginsburg, Levin and Rocap (footnote 28).
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.

Regulatory schemes outside of 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 expect that US regulators (including CFIUS) will continue to closely review any transactions with Chinese and other foreign acquirers under the Trump administration. On the other hand, practitioners generally expect President Trump to usher in a more accommodating antitrust regulatory scheme.

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 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;

b 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

37 See Kirkland Alert (January 2017) for the most recent HSR filing thresholds, available at www.kirkland.com/siteFiles/Publications/Revised_Hart-Scott-Rodino_Act_Thresholds_Announced.pdf.
39 Id.
40 This section deals only with the laws of Delaware. The laws of other states may be materially different.
41 See e.g., Abraham v. Emerson Radio Corp (Del Ch 2006).
42 See e.g., In re Loral Space and Communications Inc (Del Ch 2008).
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 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.

43 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).
44 Delaware General Corporation Law Section 102(b)(7).
45 Delaware General Corporation Law Section 145.
46 In re Trados (Del Ch 2013).
47 Geyer v. Ingersoll (Del Ch 1992).
48 North American Catholic Educational Programming Foundation, Inc v. Gheewalla (Del Sup Ct 2007).
Limited liability companies (LLCs)

Recently, private equity firms have begun to prefer Delaware 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),\(^{49}\) 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. 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 effectively US-connected income.

III DEBT FINANCING

The huge US market for acquisition debt financing is highly sophisticated and efficient, with many experienced investors and service providers and multiple options for a private equity sponsor seeking to finance an acquisition. While the market has recovered from its post-financial crisis lows, it remains sensitive – particularly for deals over US$100 million – to changes in the broader markets.

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:

\[\begin{align*}
\text{a} & \quad \text{senior and bridge loans, with the bridge loan usually backstopping a high-yield bond offering, typically used in very large deals;} \\
\text{b} & \quad \text{first-lien and second-lien loans, typically used in upper-middle-market deals, with the availability and pricing of second-lien debt highly dependent on market conditions;} \\
\text{c} & \quad \text{senior and mezzanine loans, typically used in middle-market deals;} \\
\text{d} & \quad \text{unitranche loans, which combine senior and mezzanine features into a single blended loan, typically used in middle-market deals; and} \\
\text{e} & \quad \text{senior loans only, typically only used in smaller deals or deals in which the private equity sponsor is using very little leverage.}
\end{align*}\]

Except for smaller deals (US$100 million or less), most lending facilities are arranged by a financial institution and then syndicated to other lenders,\(^{50}\) including banks, hedge funds and special purpose entities – known as collateralised loan obligations – created to invest in such loans.

Because UK-style ‘certain funds’ debt financing is not available in the US, the parties to an LBO – the lenders, the private equity sponsor and even the target – inevitably face market


\(^{50}\) 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.
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.\textsuperscript{51}

The non-pricing terms (i.e., excluding items such as fees, interest rates and original issue discounts) of an LBO loan – e.g., 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.\textsuperscript{52} 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, where financial maintenance covenants apply only to revolving credit facility draws in excess of a specified amount. 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 such changes (which may not include, however, additional conditions precedent to funding).

IV  OUTLOOK

A promising end to 2016 and start to 2017 has US private equity investors excited for 2017’s prospects. Although the continued abundance of dry powder and vibrant M&A markets provide some tailwinds for US private equity going into 2017, concerns remain: potential changes to interest deductibility rules; protectionist trade policies in the US and abroad (including border taxes), China’s slowing economy, uncertain tax and regulatory policies, and the prospect of increasing 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 regime.

\textsuperscript{51} See discussion in Section I, supra.

\textsuperscript{52} Many middle market and most – if not all – larger loans are rated by credit rating agencies such as S&P and Moody’s.
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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; and 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.
PAUL W ANDERSON
Kirkland & Ellis LLP
Paul Anderson is a corporate partner in Kirkland’s Chicago office. His practice primarily involves advising private equity firms and public and private companies in connection with structuring and negotiating complex business transactions, including domestic and international mergers and acquisitions, leveraged buyouts, going private transactions, recapitalisations, senior credit financings, mezzanine financings, restructurings, work-outs and other general corporate matters.

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 Business and 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 Program and Corporate Audit Staff.

LISA ANDREWS
McCullough O'Connor Irwin LLP
Lisa Andrews is an associate of the firm. She obtained a Bachelor of Arts from the University of British Columbia in 2008 and her JD also from the University of British Columbia in 2012. Ms Andrews was admitted to the Law Society of British Columbia in 2013 and joined the firm in 2014.

Ms Andrews practises in the areas of securities, corporate and private equity law. Her practice includes advising public and private companies on a broad range of matters, including general corporate matters, public and private offerings, mergers and acquisitions, continuous disclosure requirements and other regulatory requirements.

Ms Andrews is a member of the Securities Law, Business Law and Banking Law subsections of the Canadian Bar Association.

ANDREW ANG
WongPartnership LLP
Andrew Ang is the head of the firm’s corporate and M&A practice, and is a partner in the private equity practice.

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 several high-profile private equity transactions, including acting for Platinum Equity, in the acquisition of the foam plastics solutions and flow control device businesses of Broadway Industrial Group Limited.

He also advised PAG Asia Capital’s investment in Paradise Group Holdings Pte Ltd; Standard Chartered Private Equity (Singapore) Pte Ltd in its acquisition of the business and selected assets of Phoon Huat and Company (Private) Limited.

He graduated from the University of Nottingham. He is admitted as a barrister-at-law (Gray’s Inn) and to the Singapore Bar.

He is recognised as a leading corporate or M&A lawyer in Chambers Global, Chambers Asia-Pacific, IFLR1000, The Legal 500, Asialaw Profiles and Asialaw Leading Lawyers as a leading Singapore practitioner in the area of corporate and M&A.
He is also endorsed by Best Lawyers for both corporate and M&A and private equity and venture capital in Singapore.

HÉCTOR ARANGUA L

Nader, Hayaux y Goebel, SC

Mr Arangua specialises in capital markets, structured finance, mergers and acquisitions, private equity, and energy.

He is recognised as a leading lawyer by Chambers Latin America, IFLR1000, The Legal 500 and LL250, for his outstanding expertise. 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 that ‘he is 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 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.

He obtained his LLM from the University of Michigan Law School, having graduated as a lawyer from the Instituto Tecnológico Autónomo de México.

ALEXANDRINE ARMSTRONG-CERFONTAINE

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Alexandrine Armstrong-Cerfontaine’s practice focuses on private equity fund formation and transactions, advising private equity sponsors on their investments, corporate finance, syndicated financings (including leveraged financing and restructurings) and fund formation. She also advises sponsors on corporate finance, restructuring, compensation and retirement plans, including complex compensation schemes as part of LBO transactions.

Her team is described in The Legal 500 as a funds practice that is ‘robust, responsive and well-priced’. The editorial also describes her as having ‘very good knowledge of fund regulation and set-up issues’, ‘refreshing energy’ and giving ‘great comfort’.

KEI ASATSUMA

Nagashima Ohno & Tsunematsu

Kei Asatsuma is a partner at Nagashima Ohno & Tsunematsu. His practice focuses on complex business transactions, including M&A, divestitures, spin-offs, joint ventures, strategic alliances, leveraged buyouts, private equity investing, restructuring and workouts, and recapitalisations. He also counsels clients in a wide variety of corporate matters, including corporate governance issues, and is often called upon to represent public companies involved in takeover and active shareholder defence.

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,
and worked at Kirkland & Ellis LLP in Chicago from 2002 to 2003, where he focused on international litigation and cross-border transactions involving Japanese companies, and general corporate matters for US and Japanese companies.

CHRISTOPHER S AVELLANEDA

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Christopher S Avellaneda is an associate in the investment management, and regulatory and compliance groups at Schulte Roth & Zabel LLP. He advises hedge funds, private equity funds and funds of funds on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organisation requirements. Chris has extensive experience providing guidance to clients on establishing compliance programmes, registering with the SEC, complying with US securities trading rules and handling SEC examinations.

CONRAD AXELROD

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Conrad Axelrod is a special counsel in the investment management group at Schulte Roth & Zabel LLP, where he focuses on the formation and structuring of private equity and alternative investment funds. In addition to assisting clients with operational issues and management company structuring, Conrad has extensive experience advising on co-investment transactions in the real estate, international credit and E&P sectors. He has also guided investors and sponsors through secondary portfolio transactions and fund restructurings.

NATALIE BÄR

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Natalie Bär is a German tax adviser and has a degree in business administration from the University of Mannheim. She joined PwC in 2014. She has over 13 years of national and international corporate tax law experience, including engagements in advising financial investors and private equity funds on the German and international tax aspects.

JAMES BEEBY

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Mr Beeby is a partner of McCullough O’Connor Irwin LLP has extensive experience in advising clients with respect to all aspects of private equity investing, including formation of private equity funds, hedge funds and venture capital funds, buy-outs, debt and equity investments, co-investments and exit transactions. Mr Beeby is also experienced in structuring and negotiating transactions and in establishing proper governance standards for private equity managed businesses. Mr Beeby’s clients include private equity funds and institutional investors and he is familiar with all commonly used structures for fund formation and private equity investments.

Mr Beeby obtained an LLB (Hons) from Warwick University (England) and an LLB from the University of British Columbia and has been practicing law relating to the venture capital industry for over 20 years. Mr Beeby is recognised as a leading practitioner by Best
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MARCUS VINICIUS BITENCOURT
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Marcus Vinicius Bitencourt is a partner and co-head of the corporate area of Campos Mello Advogados. Having joined the firm in 2005 as an associate, he became a senior associate in 2008, a partner in 2012 and co-head of the corporate area in 2017. Mr Bitencourt graduated with a BA in law from the University Candido Mendes in 2002; a postgraduate qualification in business law from the Getulio Vargas Foundation (FGV) in 2005; a specialisation in corporate and capital markets law from FGV in 2007; and a certificate in investment banking from the School of Continuing and Professional Studies, New York University, 2009. He has an extensive practice in the areas of corporate law, securities and M&A, offering legal advice in all investment operations and directing Brazilian and foreign investors in mutual funds, investment companies and share portfolios. His experience also encompasses assistance with planning and structuring of business transactions and corporate activities, including incorporation; corporate reorganisations and restructurings; and assembly of joint ventures, consortiums, associations, foundations, partnerships and other methods of organising businesses, activities and enterprises.

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Mateusz Blocher joined SK&S in 2009. He specialises in private and public banking law, corporate law and commercial insurance law. He advises banks and other institutions in the financial sector. He has participated in M&A transactions and restructuring projects.

FRANCISCO BRITO E ABREU
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Francisco Brito e Abreu joined Uría Menéndez in 2001 after working as in-house counsel in the Portuguese subsidiary of a multinational corporation, a privately owned holding company and a listed Portuguese company, and as a lawyer in another prestigious Portuguese law firm. He was made partner of Uría Menéndez in January 2005. He focuses his practice on commercial and corporate law issues, and has extensive experience in corporate restructuring, M&A and private equity transactions.

NICHOLAS BUTCHER
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Nicholas Butcher is managing partner of Maples and Calder’s Dublin office. He advises on all aspects of investment funds and specialises in both hedge fund and private equity transactions. Nicholas has extensive experience of corporate, partnership and trust structures (including Japan-focused retail funds) and also advises with respect to securities investment business law as well as listings on the Cayman Islands and other worldwide exchanges.
Nicholas joined Maples and Calder 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.

Nicholas has been recognised as a leading lawyer in IFLR1000, as a rated practitioner by The Legal 500, a leading practitioner in Who’s Who Legal: Private Funds and has been ranked as a notable practitioner by Chambers Global.

FEDERICO CÁRDENAS
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Federico Cárdenas is an associate in the Bogotá office of Philippi Prietocarrizosa Ferrero DU & Uría. His legal practice focuses on private equity, capital markets and M&A. Mr Cárdenas has participated in domestic and cross-border transactions involving private equity funds, and has provided legal advice on due diligence and fund formation activities.

Mr Cárdenas has a law degree from Universidad de los Andes (2014). He was part of the exchange programme for international and comparative business law of the Bucerius Law School in Hamburg, Germany (2011). In 2014, he published an article in the Private Law Review of Universidad de los Andes analysing the legal framework of collective investment schemes and investment funds.

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Camila Caetano Cardoso is an associate in the corporate area of Campos Mello Advogados. She graduated with a BA in law from the Getulio Vargas Foundation in 2012. She has practised in the areas of corporate law, mergers and acquisitions, joint ventures and associations in general and corporate governance. Her experience also encompasses assisting with foreign investments in Brazil and corporate reorganisations and restructurings. She is a member of the Rio de Janeiro section of the Brazilian Bar Association.

LISA CAWLEY
Kirkland & Ellis International LLP
Lisa Cawley heads the financial service regulatory practice in Kirkland’s London office. She has extensive experience in both financial regulation and corporate matters, gained over 20 years. She is recognised in Chambers UK, which has described her as an ‘oasis in the desert’ when it comes to FCA regulation, and also ‘very precise and commercial’ on AIFMD matters. Chambers distinguishes her team as ‘the go-to source of counsel on the mutable regulatory landscape’. She is also recognised in Who’s Who Legal: Private Funds and The Legal 500, where she is described as a ‘master at all things regulatory in Europe’ who ‘knows how to address the regulatory complexities that have come out of the financial crisis’. In the IFLR1000 it is noted that ‘she is extremely knowledgeable and efficient. A fantastic attorney with extensive knowledge of the law and practical implications of the regulatory environment.’
CHARLES CHEVRETTE
McMillan LLP
Charles Chevrette is a member of the board of partners and the office managing partner in Montreal. He is also the national co-chair of the private equity group at McMillan LLP. Charles is recognised by Best Lawyers in Canada 2017 as a leading lawyer in the area of mergers and acquisitions law and by Lexpert as a leading lawyer in the area of private equity. Charles’ practice is focused on private equity, venture capital, mergers and acquisitions, and technology transfers. He has been involved in the formation of private equity funds and acts regularly on behalf of institutional investors in connection with Canadian, cross-border and international equity investments, acquisitions (including LBOs and MBOs), and co-investments. He has significant industry experience in information technology, telecommunication, aerospace and manufacturing sectors. Charles obtained his masters in business administration (MBA) in addition to his LLB and was called to the Quebec Bar in 1993.

Significant clients include: Novacap, Desjardins Venture Capital and Tennenbaum Capital.

GRAHAM CROSS
Addleshaw Goddard LLP
Graham is a partner in the private equity group at Addleshaw Goddard LLP in London. The private equity practice comprises nine partners across the firm’s London, Manchester and Leeds offices, and is ranked Tier 1 for mid-market private equity transactions by The Legal 500. Graham has extensive experience of private equity, mergers and acquisitions (M&A) and restructuring transactions, both in the UK and internationally. He has a particular focus on the UK financial services sector.

He regularly advises both investors and management teams in connection with all stages of the investment cycle together with portfolio management issues. Within the financial services sector, Graham has managed a variety of large and complex transactions, but with a particular focus on private equity investment in financial services sector businesses, loan sales (including advising UK banks and buyers on the transfer of substantial commercial and retail loan portfolios), M&A transactions for banks and transactions in the wealth management sector.

In 2016 he advised Synova Capital, ECI, Foresight and LDC on investments and potential investments.

FLORIAN PHILIPP CVAK
Schindler Attorneys
Florian Philipp 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, and was involved in some of the firm’s most prestigious transactions in Austria and the wider CEE region.

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 has attended extracurricular classes on private equity, corporate finance, investment banking and accounting at New York University, Stern Business School.

Mr Cvak is admitted to the Austrian and New York Bars. He has published several articles on M&A, private equity and corporate finance, and is a frequent speaker at conferences and seminars regarding private equity and corporate and M&A matters.

Mr Cvak is ranked by international legal directories such as Chambers Global and Chambers Europe, IFLR 1000 and Who’s Who Legal. He was awarded Austrian private equity lawyer of the year by ACQ5 for 2013, 2014 and 2015, and is featured in the 2014 and 2015 editions of The Best Lawyers in Austria. The Austrian business journal Format named him among the country’s top 10 CEE experts. Besides the Austrian listings, Chambers Global acknowledges his Polish expertise in a special ranking.

GERARD EVERAERT
Uría Menéndez – Proença de Carvalho
Gerard Everaert joined the Lisbon office of Uría Menéndez – Proença de Carvalho in May 2014. Prior to joining the firm, he worked at a leading consultancy firm (Deloitte). His practice is focused on tax law, specialising in real estate transactions, financial products, tax planning, mergers and acquisitions, and compliance procedures.

ROHAN GHOSH ROY
Trilegal
Rohan Ghosh Roy is a partner based at Trilegal’s Mumbai office, and is part of the corporate practice group. He has worked with several leading funds, financial institutions and multinational corporations on a broad range of matters involving equity and debt, focusing on transactions with a cross-border element, in a broad range of sectors (including e-commerce, real estate, and banking and financial services). Rohan also has significant experience in advising and assisting private equity and hedge fund clients in exiting their investments in India (in both consensual and contentious scenarios), and has acted on behalf of investors in several high-profile investment disputes in recent years.

HANS P GOEBEL C
Nader, Hayaux y Goebel, SC
Mr Goebel is a Mexican lawyer who specialises in mergers and acquisitions, private equity, capital markets, and banking and finance.

He is recognised as a leading lawyer by Chambers Latin America, IFLR1000, Best Lawyers and PLC Which Lawyer?, for his outstanding expertise. Chambers Latin America ranks him as a leading individual for capital markets, describing him as a ‘tremendous negotiator’, and also note 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 ‘he has a 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 School of Law of Chicago. He graduated as an attorney from the Instituto Tecnológico Autónomo de México and has lectured in financial contracts at the Universidad Iberoamericana. He currently acts as independent director and board secretary of various financial institutions.

**TIM GORDON**
*Gilbert + Tobin*

Tim Gordon is a partner in Gilbert + Tobin’s corporate advisory group with expertise in corporate governance, mergers and acquisitions, capital markets, private equity and distressed restructuring transactions. Mr Gordon holds a Master of Laws degree in corporate and commercial law from the University of New South Wales. *Best Lawyers* recognises Tim as a leading lawyer in equity capital markets.

**CHRISTOS GRAMATIDIS**
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Christos Gramatidis is a graduate of the Democritus University of Thrace Law School and has been a registered member of the Athens Bar Association since 2008. He specialises in the areas of banking and finance, privatisations, M&A and energy. His experience includes acting on a wide range of complex Hellenic Republic privatisation projects, structured finance and acquisition transactions. His practice includes advising clients on product liability, mining and energy regulatory matters. He is also extensively active on human rights issues on a pro bono basis. He speaks English, French and German.

**EKTA GUPTA**
*Shardul Amarchand Mangaldas & Co*

Ekta Gupta is a corporate, M&A and PE partner at the firm. Ekta has advised many private equity funds across the full range of their operations and activities and has extensive experience in matters pertaining to fund formation and portfolio investments by the funds. Some of her notable transactions include advising Blackstone in relation to the 100% buy-out of the two sea-plane operating companies in the Republic of Maldives, which was nominated as ‘Private Equity Deal of the Year’ by IFLR Asia Awards 2014. She has also advised Blackstone in relation to the acquisition of a controlling stake in Agile Electric Supply Private Limited and advised Temasek in relation to its investments in Devyani International Limited, Zomato and Car Trade. In another major deal, she represented Paytm in relation to a multi-staged investment in it by Alibaba and Alipay.

**FRANCISCO GUZMÁN**
*Carey*

Francisco Guzmán is a partner of Carey. He concentrates his practice in M&A, fund formation, private equity and venture capital transactions.

Mr Guzmán was awarded an LLM from Columbia Law School in 2010 (a James Kent Scholar, the highest honour awarded by the law school) and a JD from the Catholic
University of Chile in 2006. He is admitted to practise law in New York (2010) and Chile (2006). Prior to working at Carey, Mr Guzmán practised at White & Case LLP in New York.


Mr Guzmán has been recognised as one of the leading lawyers in Chile in M&A by *Who’s Who Legal* and *Latin Lawyer*.

**PETER HAMMERICH**

*BA-HR DA*

Peter Hammerich is a partner at BA-HR law firm, and head of BA-HR’s asset management and private equity group. Having practised within asset management, investment funds and private equity for more than 20 years (12 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**

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Markus Heistad is a lawyer at BA-HR in its asset management practice group. Before joining BA-HR, 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.

**GISELLE HERRERA**

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Giselle Herrera is a member of Philippi Prietocarrizosa Ferrero DU & Uría’s capital markets, mergers and acquisitions, and private equity teams. Ms Herrera specialises in financial and capital markets transactions, with relevant experience in international bond issuances, financial derivate and private equity matters. Ms Herrera’s practice also includes cross-border M&A deals, providing legal advice in acquisitions, mergers, and joint ventures of domestic and foreign companies, both during due diligence processes and during the negotiation and drafting of transaction documents. Ms Herrera regularly advises clients in private equity matters, including fund formation activities and M&A transactions involving private equity funds.

Giselle Herrera holds a law degree (*cum laude*) and a minor in economics from Universidad de los Andes. During law school, Ms Herrera worked as a teaching assistant for various law courses and was a member of the 2009 world champion team in the Philip C Jessup International Law Moot Court Competition. Prior to joining the firm, Ms Herrera worked in the Permanent Court of Arbitration in The Hague, the Netherlands, providing legal support to arbitral tribunals and parties in international arbitration proceedings.
CHRISTIAN HOEDL
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Christian Hoedl is a partner at the M&A and private equity practice area at Uría Menéndez. 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 & Partners, PLC* and *Who's Who Legal*).

WOJCIECH IWAŃSKI
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Dr Wojciech Iwański joined SK&S in 2006, and 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 Polish Financial Supervision Commission. 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.

DEBORAH JOHNS
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Deborah Johns is a partner at Gilbert + Tobin in the corporate advisory group. She advises clients on business acquisitions and disposals, complex joint ventures, fund establishment, venture capital, corporate governance, and general corporate and commercial matters. She is an expert on the Foreign Acquisitions and Takeovers Act 1975 (Cth).

Deborah has been ranked as a ‘Best Lawyer in Funds Management’ since 2014 and has been identified as a ‘Noted Practitioner’ for investment funds in *Chambers*. She has been interviewed on television and radio in relation to foreign investment issues.

Prior to joining Gilbert + Tobin, Deborah worked in the Hong Kong office of a New York-based law firm, and in the Chicago and Shanghai offices of a Chicago-based law firm, in both cases focusing on venture capital and private equity.

Deborah holds a bachelor’s of science in foreign service from Georgetown University, with a certificate in Asian studies and certified proficiency in Mandarin Chinese. She received a fellowship to pursue a year of graduate studies at Taiwan’s National Chengchi University and received a JD with honours from the University of Michigan Law School.

ALEX JORGE
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Alex Jorge is a partner in the tax area of Campos Mello Advogados and co-head of the tax practice, based in São Paulo. He joined the firm in 2013, and brought to the firm his 15 years of experience as in-house counsel for US multinationals. Mr Jorge graduated with a BA in law from the Catholic University, School of Law (PUC) of São Paulo in 1996; an LLM in taxation in the same university, in 1998 and a LLM in banking, corporations and finance
About the Authors

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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 a part-time lecturer (civil law) at the law faculty of the University of Tokyo since 2016.

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Heinrich Knepper joined Hengeler Mueller in 1995 and became a partner in 2001. He specialises in banking and finance, mergers and acquisitions as well as restructuring transactions. He studied law in Regensburg and Paris. He has advised numerous corporate clients as well as PE clients, banks and other financial investors on acquisition finance, M&A transactions, as well as general balance sheet lending transactions (both leveraged and investment grade) and acquisition financings. Recent transactions include advising Goldman Sachs in connection with the acquisition of the Lindorff Group, the acquisition financing by way of a credit agreement and notes, the acquisition of LR Health & Beauty Systems by the PE firms Bregal and Quadriga, including in particular advising on the financing by way of a leveraged acquisition financing, a €1.9 billion financing of a German offshore wind park by way of a combined senior, mezzanine and equity financing, and, recently, advising Blackstone on the financing of a 3 billion real property portfolio in Germany. Heinrich Knepper is also a long-term adviser of the INEOS Group in respect to its senior loan and high-yield financings.

ALJOŠA KRDŽIĆ

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Aljoša Krdžić is an associate at Rojs, Peljhan, Prelesnik & partners. He graduated *cum laude* from the University of Ljubljana in 2012, and in 2015 he passed the state bar exam. Aljoša practises corporate law, with a primary focus on M&A, competition law, banking and finance, and real estate law. Aljoša actively participates in almost all of the firm’s M&A deals. Recently he has been actively engaged in private equity transactions involving a foreign private equity fund acquiring shares of a Slovenian paper tissue producer, and a UK private equity management company investing in various companies and assets in Slovenia. Since 2012, when he started working for the firm, Aljoša has also led the team advising a major manufacturer of plastics in the process of its acquisition of the Slovenia-based company and coordinating consolidation of its business, participated in advising a major glass product manufacturer in its pursuit of the acquisition of a well-known Slovenian glass manufacturer,
and has advised several private equity investors in their pursuit to acquire shares or assets in various business sectors in Slovenia.

TIM KREUTZMANN

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Tim Kreutzmann is a German lawyer and certified specialist for German tax law. His professional focus is on investment regulatory and investment tax law. He specialises in legal and tax advice for asset management companies and institutional investors as well as investor-specific regulation (Investment Ordinance and Solvency II).

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Christy is 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’, whose ‘effective negotiating style’ has earned her ‘particular plaudits’. She is also recommended as ‘someone you would always want to have on your side’ and praised for her ‘skills and proficiency’, ‘whose strong grasp of securities, acquisitions and debt restructurings makes her a lawyer of choice for a number of major private equity houses and investment banks’. Known for her ability to ‘handle the counsel on the other side very well, so that a reasonable outcome can be struck’, she earns praise for her ability to ‘breeze through otherwise lengthy negotiations and appreciate commercial realities on transactions’. She is identified as a leading practitioner by IFLR1000: Financial & Corporate and as a ‘key player’ by The Legal 500: Asia Pacific. Christy is also recognised as a leading finance practitioner by Best Lawyers.

She graduated from the National University of Singapore and is admitted to the Singapore Bar.
XIAOXI LIN
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Xiaoxi Lin is a partner in Kirkland & Ellis’s Hong Kong office. He focuses his practice on mergers and acquisitions, where 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.

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Samuel Ljubicic was admitted to the bar in Switzerland in 2010. He holds a degree from the University of Lucerne and a master’s from King’s College London in international financial law. His principal areas of work include M&A, banking and finance, capital markets as well as real estate development and transactions. He has recently been involved in various highlight financing transactions, national and cross-border acquisitions for Swiss and international clients.

JOHAN LOUBSER
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Johan Loubser is a director at ENSafrica in the banking and finance department and specialises in debt and preference share funding transactions; private equity funds, hedge funds and collective investment schemes and in financial services law.

Johan’s experience includes acting for institutional investors and asset managers in relation to private equity and hedge funds.

Johan is recognised as a leading lawyer by: The Legal 500 Guide to Outstanding Lawyers 2016, 2015, 2014 – Investment Funds (South Africa) and Best Lawyers 2017, 2016 – Banking and Finance (South Africa).

LOW KAH KEONG
*WongPartnership LLP*

Low Kah Keong is the head of the asset management and funds practice, and is a partner in the corporate and mergers and acquisitions practice.

His main areas of practice are mergers and acquisitions, corporate finance, asset management and collective investment schemes.

In the arena of asset management, Kah Keong has acted for sponsors and fund managers of private equity funds, real estate funds, venture capital funds, hedge funds and regulated collective investment schemes. He advises on structuring, regulatory and licensing issues, and assists in structuring funds in a tax-optimised manner using the Singapore Tax Resident Fund
About the Authors

Scheme. In his practice, he has also advised sovereign wealth funds and insurance companies in their capacity as limited partners.

Kah Keong is recommended as a leading practitioner in Investment Funds work in The Legal 500: Asia Pacific; Expert Guides; Chambers Asia Pacific since 2010 and Best Lawyers in the area of Mutual Funds. He is also recommended as a leading lawyer by Asialaw Leading Lawyers in the areas of investment funds (since 2013) and financial services regulatory in 2014.

He graduated from the National University of Singapore. He is admitted to the Singapore Bar and to the Roll of Solicitors of England and Wales.

JONATHAN MCCULLOUGH
McCullough O’Connor Irwin LLP

Jonathan McCullough is a founding partner of the firm and has been practicing corporate and securities law for more than 30 years. He has spoken at numerous legal education conferences, has published articles on corporate law issues and has participated on an advisory committee to a Canadian stock exchange. He is recognised as a leading practitioner in the following publications: Lexpert Magazine, Best Lawyers in Canada, Who’s Who Legal of Business Lawyers, IFLR’s Guide to the World’s Leading Private Equity Lawyers, PLC’s Cross-Border Private Equity Handbook, Expert Guides – Private Equity, Chambers Canada.

A focus of his practice is private fund transactions, acting on behalf of both fund sponsors and institutional investors in organising domestic and international private funds to invest in buyouts, mezzanine, venture capital, infrastructure and timber assets. He is familiar with all aspects of structuring, negotiating and completing such investments and with standards for investment policies, fees, returns and governance in this emerging asset class. Additionally, he has significant experience in assisting such funds with transactions, including investments, mergers and acquisitions, recapitalisations and exits. Additionally, he has significant experience in advising participants in investment consortiums on international governance arrangements.

IAIN MCMURDO
Maples and Calder

Iain McMurdo is a partner in the investment funds group and global head of the private equity group of Maples and Calder, and is based in the Cayman Islands. He specialises 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 Maples and Calder in 2008. He was previously a partner at another 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, and recognised as a leading lawyer in The Legal 500, IFLR1000 and the Legal Media Group Guides to the World’s
Leading Lawyers. He has also been ranked in Band 1 as a notable practitioner by *Chambers Global*.

**Srishti Maheshwari**  
*Shardul Amarchand Mangaldas & Co*

Srishti Maheshwari is an 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.

**Maud Manon**  
*DLA Piper France LLP*

Maud Manon is a finance partner at DLA Piper. She is also the finance and projects department location head of the Paris office.

She began her career in 1998 in the Paris office of White & Case before joining the finance team in the Paris office of Ashurst Morris Crisp. In 2001, Ms Manon joined the Paris office of Linklaters, where she spent five years in the finance team before becoming counsel at Latham & Watkins in Paris in 2006. She joined Frieh & Associés as a partner in September 2009 before joining DLA Piper in October 2012.

Ms Manon’s practice primarily focuses on acquisition finance, representing financial institutions (senior (banks or debt funds) and mezzanine lenders) as well as sponsors.

Her expertise extends to the financing of the acquisition of listed companies (public offerings and block acquisitions) and corporate syndicated loans. She also advises debtors, creditors and sponsors in the context of debt restructuring operations.

**Tatiana Martins**  
*Campos Mello Advogados*

Tatiana Martins is an associate in the corporate area of Campos Mello Advogados, where she has been working for the past four years. She graduated with an LLB from the Brazilian Institute of Capital Markets (IBMEC) in 2015. 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 to accomplish their daily obligations before the Brazilian Securities Commission.

**Andrés C Mena**  
*Kirkland & Ellis LLP*

Andrés Mena is a partner in the New York corporate group of Kirkland & Ellis LLP. He concentrates his practice on debt finance and secured lending, specifically in acquisition and leveraged financings for private equity and corporate clients. He has worked on a broad range of LBO financings, including cross-border, working capital, asset-based, restructurings and debtor-in-possession transactions. He is part of the firm’s Latin American practice.
Mr Mena is a graduate of the University of Chicago Law School (LLM, 2000) and the Universidad de Chile in Santiago (JD, 1998). Prior to being admitted to the New York Bar, he practised in Chile as an associate at Morales & Besa in Santiago, focusing on corporate finance matters.

RAGHUBIR MENON
Shardul Amarchand Mangaldas & Co
Raghubir Menon is a corporate, M&A and PE partner at the firm. He is an expert on matters pertaining to private equity, joint ventures, and mergers and acquisitions. Raghubir 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, Temasek, GIC and IDFC Alternatives. He represents investment and commercial banks, private equity funds, multilateral agencies and strategic corporate clients on a variety of domestic and cross-border transactions.

Raghubir won the M&A Lawyer of the Year: Private Equity for Asia Pacific at the Asian Lawyer Emerging Markets Awards 2015 for the work undertaken over 2015. As ‘one of the few lawyers that has the combination of both commercial and legal skills,’ Raghubir Menon enjoys a formidable reputation in the private equity market. ‘He would always be available and meet the deadlines without compromising on quality. We were more than impressed,’ explains one client, as quoted by Chambers and Partners.

Prior to joining Shardul Amarchand Mangaldas, Raghubir has worked with White & Case LLP, in London and Singapore, for five years. Raghubir is 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).

CHRIS MORSE
Gilbert + Tobin
Chris Morse is a lawyer in Gilbert + Tobin’s corporate advisory group. Chris’s practice involves advising on a range of corporate and securities law matters, with a particular focus on mergers and acquisitions, private equity and venture capital transactions, initial public offerings and equity capital markets transactions.

FELICIA MARIE NG
WongPartnership LLP
Felicia Marie NG is a partner in the asset management and funds practice.

Her main practice area lies in private investment funds. She regularly advises fund managers and sponsors in the establishment and structuring of hedge funds, real estate funds, venture capital funds and private equity funds as well as institutional investors and sovereign wealth funds as investors of alternative investment funds. She also advises clients on tax exemption schemes for Singapore resident funds as well as regulatory compliance and licensing issues relating to Singapore securities and financial advisory law.

Significant transactions that Felicia has been involved in include acting for Canada Pension Plan Investment Board in relation to its US$375 million investment representing a 25 per cent stake in Raffles City China Investment Partners III, with a fund size of US$1.5 billion; the sponsor and fund manager of Lion-OCBC Capital Asia Fund I, LP,
which is the first private equity fund established by OCBC Bank to invest in Singapore, Malaysia, Indonesia and China which raised S$550 million.

Felicia is a recommended lawyer in *The Legal 500: Asia Pacific* for the area of investment funds in Singapore. She graduated from the National University of Singapore and is admitted to the Singapore Bar.

**ANDRÉS NIETO SÁNCHEZ DE TAGLE**

*Von Wobeser y Sierra*

Andrés Nieto Sánchez de Tagle is a partner at Von Wobeser y Sierra, S.C. with more than 18 years’ professional experience in Mexico, New York and Latin America. His clients appear in Fortune 50 and Fortune 500, as well as the Dow Jones, NASDAQ, S&P 500, DAX and the Nikkei. He has a multidisciplinary practice, with an emphasis on cross-border transactions, which includes experience in several of the principal transactions that have taken place in Mexico and the United States in the legal areas of banking and finance, securities, corporate, mergers and acquisitions, as well as in private equity, structured financing, project finance, arbitration and mediation.

Currently, he advises many foreign companies in 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 in 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.

**STIG NORDAL**

*Advokatfirmaet Steenstrup Stordrange DA*

Stig Nordal is a partner at Steenstrup Stordrange and works in the firm's technology group. He has nearly 20 years’ experience within his fields of expertise. Mr Nordal specialises in national and international tax matters and M&A in the private equity market. He has extensive knowledge related to the structuring of funds and transactions, advising target or portfolio companies as well as the buying of funds. Further, he has extensive knowledge in establishing incentive schemes and earn-out models. He holds board positions in several portfolio companies in the private equity market, and others in early stage or pre-seed funds. In addition to his master's degree in law, he also holds a master's of education degree in entrepreneurship and innovation from BI Norwegian Business School.

**XAVIER NORLAIN**

*DLA Piper France LLP*

Xavier Norlain is a corporate partner at DLA Piper. He is also the corporate department location head of the Paris office.

Specialising in mergers and acquisitions, Mr Norlain advises numerous investment funds on leveraged buyouts, venture capital and development capital transactions, as well as industrial or service groups on their equity finance operations, restructuring and external growth transactions.

He also advises managers on the definition of their status and their remuneration, as well as in the context of operations associating them with investment funds. Finally, Mr Norlain advises fund management teams themselves on the structuring and setting up of new investment vehicles.

RYO OKUBO

*Nagashima Ohno & Tsunematsu*

Ryo Okubo is a partner at Nagashima Ohno & Tsunematsu. 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, and any type of cross-border transactions. He also frequently provides advice related to IT or technology-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.

MARCEL OLECHOWSKI

*Sołtysiński Kawecki & Szeląg*

Dr Marcin Olechowski leads the banking and finance practice of Sołtysiński Kawecki & Szeląg. He advises clients on complex bank and financial regulatory matters and represents them in proceedings in front of the Polish financial markets regulator. 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 international arbitration.

STEFFEN OPPENLÄNDER

*Hengeler Mueller*

Steffen Oppenländer is a London-based partner with Hengeler Mueller specialising in M&A and PE. He studied law in Freiburg and Munich and holds a PhD in law (University of Bonn). He joined Hengeler Mueller in 2003 and spent one year as foreign associate at Simpson Thacher & Bartlett in New York (2005). In 2009, Mr Oppenländer became a partner of Hengeler Mueller based in Munich, from where he relocated to Hengeler’s London office in 2013. He has advised numerous German and international corporations, various family businesses and PE investors on M&A transactions and joint ventures. His most recent transactions include the sale of Armacell group by Charterhouse to a consortium of Blackstone and Kirkbi, the acquisition of Wittur group by Bain Capital and the following add-on acquisition of Sematic group by Wittur, and the sale of SAG by EQT to SPIE.
LUIZ AUGUSTO OSORIO

_Campos Mello Advogados_

Luiz Augusto Osorio is a senior associate at Campos Mello Advogados, based in Rio de Janeiro. Having joined the firm in 2005 as an intern, he became a senior associate in 2012. He graduated with a BA in law from the Pontifícia Universidade Católica PUC-Rio in 2005, and gained a postgraduate qualification in private and property law from the Pontifícia Universidade Católica PUC-Rio in 2008 and a specialisation in accountancy from FGV in 2009. He practises in the areas of corporate, securities, mergers and acquisitions and contracts.

MACKY O’SULLIVAN

_King & Spalding LLP_

Macky O’Sullivan is a senior associate at King & Spalding LLP. Mr O’Sullivan mainly advises clients on cross-border mergers and acquisitions, financial services regulation and investment funds and transactions. 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 Victoria Capital Partners, 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, TGI, ETB and BBVA.

Mr Padilla has a law degree from Universidad de los Andes (1997) and a postgraduate degree in international corporate law from Universidad de los Andes (1997). In addition, he has an LLM from Northwestern University School of Law (1999) and a certificate of management from Kellogg School of Management (1999). Mr Padilla is licensed to practise law in Colombia and in the state of New York.
GREGOR PAJEK
Rois, Peljhan, Prelesnik & partners o.p., d.o.o.

Gregor Pajek is a partner at Rojs, Peljhan, Prelesnik & partners and joined the firm in 2010 after his LLM studies and traineeship in the capital markets group at the Frankfurt office of Baker McKenzie. His fields of expertise include banking, capital markets, finance transactions, and M&A, in which he regularly assists foreign and domestic clients. Recently, Gregor acted in privatisations, private acquisitions, public takeover offers, debt refinancing and restructuring, acquisition finance, securitisations and structured finance transactions involving debt and equity. He also advised international banks and asset management companies in various regulatory issues including the cross-border provision of services and provision of services under the AIFMD regime. In the commercial sector he has recently advised companies in covered bonds issue as well as in cash pooling and liquidity management programmes. He regularly advises clients on acquisition financing, takeovers and squeeze-outs, and has recently worked on, inter alia, the acquisition of Mercator (the largest Slovenian retailer), a telecommunications operator in Slovenia and in the Helios privatisation. His notable practice area is also the post-acquisition integration process where Gregor advises on general corporate law. Gregor regularly advises domestic and foreign banks and commercial companies in various insolvency-related matters.

NISHANT PARIKH
Trilegal

Nishant Parikh is a partner based at Trilegal’s Mumbai office, and represents a broad range of private equity funds, hedge funds, banks and financial institutions on complex cross-border transactions. His practice focuses on advising clients in evaluating, structuring and negotiating private equity investments and acquisitions, structured financing and investments, and the restructuring of existing investments. He has considerable experience in implementing exit strategies in contentious or distressed situations, and has been involved in structuring and successfully implementing exit strategies for some of the biggest funds and financial institutions in connection with their Indian investments. He has extensive experience across several sectors (with a particular focus on real estate, banking and financial services, IT and e-commerce, and agribusiness, in addition to the broader manufacturing and services sectors), advising on regulatory issues that typically arise in Indian deals and negotiating with Indian promoters.

NATHAN PEARCE
Addleshaw Goddard LLP

Nathan is a partner in the private equity group at Addleshaw Goddard LLP in London. The private equity practice comprises nine partners across the firm’s London, Manchester and Leeds offices, and is ranked Tier 1 for mid-market private equity transactions by The Legal 500. Nathan previously worked in the private equity groups at Clifford Chance in London and at Hogan Lovells in London, Frankfurt and Prague.

He acts on all aspects of domestic and cross-border mergers and acquisitions, joint ventures and restructurings, with a particular focus on private equity and other financial sponsor-led transactions (for both sponsors and management teams) and advising high-net-worth individuals and families.
In 2016, his notable transactions included advising the management of P3 Logistics on the €2.4 billion sale of P3 by TPG to GIC of Singapore, the management of R&R Ice Cream on its combination with the Nestlé frozen food business to create Froneri (a €2.5 billion turnover business operating worldwide), Phoenix Equity Partners on its investment in Rayner Surgical Group and Pollen Street Capital on the acquisition of iCheque by its portfolio company Cashflows.

JAN PIERZGALSKI
Sołtysiński Kawecki & Slezak
Jan Pierzgalski joined SK&S in 2013. He specialises in private banking law, corporate law and capital markets law. He advises banks, public companies and public companies’ 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.

ARTURO POBLETE
Carey
Arturo Poblete is a senior associate in the M&A and capital markets practice of Carey in Santiago, Chile. He concentrates his practice in M&A, private equity and capital markets transactions.

Mr Poblete is a graduate of the University of Chicago Law School (LLM, 2015) and the Universidad Católica de Chile in Santiago (JD, 2009). Prior to working at Carey, he practised as a foreign associate at the New York office of Kirkland & Ellis LLP (2015–2016).

Mr Poblete has been recognised as an ‘associate to watch’ by Chambers Latin America 2015, 2016 and 2017.

MARTA PONTES
Uría Menéndez – Proença de Carvalho
Marta Pontes joined the firm in 2004 to work in the Lisbon office. Before joining Uría Menéndez, she worked in a Portuguese law firm and in a leading consultancy firm (Ernst & Young). She became a partner in January 2014. She focuses on tax law, specialising in the following areas: real estate transactions, financial products, capital markets, and mergers and acquisitions. She has written several articles on tax issues, and frequently participates as a speaker at seminars and conferences pertaining to her fields of expertise.
QUAK FI LING
WongPartnership LLP
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 acted for GMG Global Ltd in the preconditional offer by Halcyon Agri Corporation Limited; KKR Credit Advisors (US) LLC in its investment in JBF Industries Limited and JBF Global Pte Ltd (JBF Investment); and Keppel Infrastructure Trust (KIT) in relation to the combination of KIT and CitySpring Infrastructure Trust. She was also involved in the acquisition by Kohlberg Kravis Roberts & Co LP (KKR) of MMI Holdings Limited via a scheme of arrangement (MMI Scheme) and advising Morgan Stanley Asia (Singapore) Pte as financial adviser in KKR’s acquisition of Unisteel Technology International Limited.

The JBF Investment deal was awarded ‘Private Equity & Venture Capital Deal of the Year’ by Indian Business Law Journal 2015 and the MMI Scheme was recognised as the ‘Best Leveraged Financing’ deal by FinanceAsia.

Fi Ling graduated from the National University of Singapore and is admitted to the Singapore Bar.

DEEPA REKHA
Shardul Amarchand Mangaldas & Co
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 mergers and acquisitions and has represented clients such as Blackstone, Temasek, Rabobank and KKR. Her major deals include assisting Blackstone’s investment in IBS Software Services Private Limited and helping Rabobank set up its India-focused agri fund.

STEPHEN L RITCHIE
Kirkland & Ellis LLP
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 corporate/M&A/private equity every year from 2006 to 2017. 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 2017 and as one of Illinois’ Super Lawyers every year from 2005 to 2006 and from 2008 to 2017. He has been recognised by The Legal 500 US from 2012 to 2016 for his work in private equity buyouts.

Mr Ritchie has handled many private equity, LBO, venture capital and M&A transactions for GTCR, CHS Capital, Chicago Growth Partners, Evergreen Pacific Partners,
William Blair Capital Partners, Wind Point Partners, Technology Crossover Ventures, 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’ (2011 to present), and is a member of the American Bar Association.

JOSÉ MARIA RODRIGUES
Uría Menéndez – Proença de Carvalho

José Maria Rodrigues joined Uría Menéndez in 2010 as a trainee. He is an associate of the firm. His practice is focused in M&A, private equity, joint-ventures, and corporate and commercial law generally. He also devotes a significant part of his practice to finance, including acquisition, project and real estate finance.

BORYS D SAWICKI
Soltyński Kawecki & Szlezak

Borys D Sawicki joined SK&S in 1998 and specialises in banking and finance transactions, focusing on project finance and other structured financings. His area of expertise also includes leveraged finance transactions. He has been working closely for several years with the European Bank for Reconstruction and Development, providing advice in the fields of project finance, local self-government regulations, public aid and public procurement laws. In the field of corporate law, he has successfully completed a number of mergers and acquisitions of entities of various sectors and provides day-to-day corporate advice to numerous clients of the firm.

JEREMY SCEMAMA
DLA Piper France LLP

Jeremy Scemama is a corporate partner at DLA Piper. He practised law between 2000 and 2008 at the Paris and New York offices of Willkie Farr & Gallagher where he mainly specialised in public M&A transactions. He joined Frieh & Associés as a partner in April 2008 before joining DLA Piper in October 2012.

He has notably advised industrial groups and investment funds on a large number of transfers, acquisitions and mergers of listed companies (by means of cash tender offers, exchange tender offers, buyout offers, squeeze-outs or standing market offers) or minority interest acquisitions.

Mr Scemama is also very active in private equity 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, as well as with Wachtell Lipton Rosen & Katz in New York. His track record includes some of the largest and most prestigious Austrian and Austria-related transactions, such as the initial investment of América Móvil into Telekom
Austria or Infineon’s sale of its wireless business to Intel, as well as many private equity deals for international funds such as ARES, ARDIAN, Apax, DBAG, EQT, HIG, Internos, Kennet, Melrose, MDP, OpCapita, Riverside, Sankaty, Triton and TVM Capital.

Mr Schindler’s practice focuses on corporate and tax law advice in relation to public and private M&A, private equity and corporate reorganisations (including mergers, spin-offs and migrations), most of which have a cross-border element. Furthermore, Clemens is specialised in international holding structures. His practice is complemented by private client work (e.g., as counsel to families owning stakes in large companies).

Mr Schindler is ranked by leading international legal directories including Chambers Global, Chambers Europe, The Legal 500, IFLR1000 and Who's Who Legal. The German legal directory JUVE singles him out as one of Austria’s top 20 corporate/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.

GUIDO SCHLIKKER
PwC

Guido Schlikker is a certified German lawyer. He joined PwC in 2008. Guido advises alternative investment fund managers as well as German institutional investors (insurers, pension schemes, family offices) with respect to setting up new funds and investments in alternative funds (in particular private equity, private debt and infrastructure) from a regulatory and investment tax law perspective.

ANIRUDDHA SEN
Trilegal

Aniruddha Sen is a partner based at Trilegal’s Mumbai office, and is part of the corporate practice group. His primary practice areas are mergers and acquisitions, private equity and venture capital. He advises both international and domestic clients on complex cross-border transactions, exits, investments, asset sales, spin-offs, mergers and amalgamations. He also has experience of structured finance and instruments, and has advised several international clients on restructuring their investments in debt instruments such as fully or optionally convertible debentures, non-convertible debentures, bonds and foreign currency convertible bonds.

KEIKO SHIMIZU
Nagashima Ohno & Tsunematsu

Keiko Shimizu is a partner at Nagashima Ohno & Tsunematsu. One of the focuses of her practice is securities and financial services regulations, 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 fund of funds. She also handles a variety of corporate transactions and general corporate affairs, and she advises clients on data protection matters (including compliance with 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 currently works at Nagashima Ohno & Tsunematsu NY LLP.

SAYF SHUQAIR
King & Spalding LLP
Sayf Shuqair is an associate in the Middle East and Islamic finance practice group of King & Spalding, based in the affiliated Riyadh office. Mr Shuqair mainly advises clients on corporate mergers and acquisitions and private equity transactions, in addition to advising 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.

ANDREA SIEBER
Meyerlustenberger Lachenal
Andrea Sieber was admitted to the bar in Switzerland in 2003. She holds a degree from the University of St Gallen Law School and a master's from the University of California, Davis, School of Law. She is a partner and member of MLL's M&A/corporate group. She specialises in national and international mergers and acquisitions, private equity and capital market transactions as well as national and international company reorganisations. She also advises Swiss and foreign clients on collective investment schemes and on issues related to general corporate law, contract law and commercial law. She serves as a member of the supervisory board of a German listed company.

MARCELO SIQUEIRA
Campos Mello Advogados
Marcelo Siqueira is a senior associate in the tax area of Campos Mello Advogados, having joined the firm in 2015. He graduated with a BA in law from the Pontifical Catholic University of Rio de Janeiro in 2002; obtained a lato sensu postgraduate qualification (LLM) in corporate law and capital markets law from 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 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.
JOSEPH A SMITH  
*Schulte Roth & Zabel LLP*

Joseph A Smith is a partner in the investment management group at Schulte Roth & Zabel LLP. Joe’s practice focuses on the formation and operation of private equity funds, as well as private equity transactions, real estate capital markets and REITs. He represents US and international private equity fund sponsors and institutional investors in connection with fund formation, the acquisition and disposition of portfolio investments and the implementation of exit strategies. In this capacity, he advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. Joe has extensive experience with all alternative asset classes, including venture capital and later-stage growth equity investments, leveraged buyouts, mezzanine investments, real estate ventures and opportunity funds, as well as secondary investments and funds of funds.

MAGDA SNYCKERS  
*ENSafrica*

Magda Snyckers is a director in ENSafrica’s tax department. She specialises in providing tax and exchange control advice to corporates, trusts, funds and other entities in the financial services sector.

Magda’s experience includes advising clients on income tax, capital gains tax, dividends tax, withholding tax on interest, international tax (including double taxation relief), securities transfer tax and exchange controls.

Her experience further includes advising on the South African and cross-border tax and exchange control implications of financing transactions, corporate structures, cross-border or international structures, corporate M&A (locally and abroad), as well as investments by pension funds, local and foreign collective investment schemes, hedge funds and private equity funds.

Magda also assists local and foreign investors with the drafting and submission of exchange control applications, and assists taxpayers with the resolution of their disputes with the South African Revenue Service.

JAMES STULL  
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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 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 the United States.
URH ŠUŠTAR

Law firm Rojs, Peljhan, Prelesnik & partners o.p., d.o.o.

Urh is an associate at Rojs, Peljhan, Prelesnik & partners, a leading Slovenian corporate law firm, where he practises corporate law, with a primary focus on M&A and capital markets law, competition law, intellectual property law, and litigation.

Urh graduated from the University of Ljubljana (with a master's degree in commercial law) with honours in 2014. As a part of his commercial law specialisation, Urh has attended courses on German civil law, capital markets regulation and private equity transactions at the University of Munich, and on insurance law at the University of Münster. Recently, Urh has been engaged in private equity transactions involving a white-shoe investment bank acquiring a sports equipment manufacturer, a Luxembourg private equity fund acquiring two shopping malls, and an Austrian MBO transaction in the timber industry. Apart from that, Urh has been advising one of the largest German retail market private equity fund managers on entry into the Slovenian market and a global alternative investment fund manager on the marketing of its investment funds.

HUIMIN (AMIE) TANG

Kirkland & Ellis International LLP

Huimin (Amie) Tang is a corporate partner in the Hong Kong office of Kirkland & Ellis International LLP. Amie focuses on M&A and private equity matters, and has represented a number of leading private equity funds, as well as public and private companies, in connection with their investments and M&A transactions, including private equity investments, public M&A, going-private transactions and cross-border transactions.

JOANA TORRES EREIO

Uría Menéndez – Proença de Carvalho

Joana Torres Ereio joined Uría Menéndez as a trainee lawyer in September 2007 and became a senior associate in September 2012. Joana focuses her practice on corporate and commercial law, M&A, private equity and restructurings. Joana has a postgraduate qualification in commercial law from and attended a course on finance and accounting at the Universidade Católica, and also completed an intensive course on corporate finance at the Universidade de Lisboa.

ADALBERTO VALADEZ

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Mr Valadez specialises in taxation matters, and he concentrates his practice on federal income tax and international tax, including cross-border M&A and joint ventures, inbound investments into Mexico, as well as structuring and implementation of collective investment vehicles (such as private equity funds) managed by Mexican and foreign sponsors.

He has solid experience in advising his 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 making investments in Mexico, or which have commercial relationships with companies in Mexico. He also spent
six months working as a foreign associate in the Amsterdam, Luxembourg and Geneva offices of Loyens & Loeff.

He graduated with honours as an attorney from the Instituto Tecnológico Autónomo de México (ITAM).

GUILLAUME VALOIS

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Mr Valois has strong expertise in domestic and cross-border M&A transactions and group reorganisations (in particular acquisitions, mergers, LBOs, joint ventures). He advises investment funds and companies as well as managers and individuals.

He has also expertise on the tax structuring of real estate investments and serves French REITs (SIIC) and management companies of real estate investment funds. He deals with dispute resolutions, tax structuring of distressed M&A transactions (debt and equity restructuring) and complex individual matters.

JAN VIVIERS

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Jan Viviers is a director at ENSafrica in the corporate commercial department.

He specialises in mergers and acquisitions, corporate restructuring, financial services, financial markets and securities law. He has acted for various large corporate institutions, local and international investment funds, insurance companies and asset management companies.

Jan’s experience includes acting for Metropolitan Holdings Limited in its merger with Momentum Group Limited, a merger with a transaction value of 30 billion rand, various other large acquisitions, matters relating to the Takeover Regulation Panel and the Listing Requirements of the JSE, as well as the structuring and restructuring of local and international private equity and venture capital funds.

Some of Jan’s other areas of focus in the firm include black economic empowerment transactions and the Black Economic Empowerment Codes of Conduct. He has spoken at various conferences on matters in the financial services industry, as well as on BEE transactions and Codes of Conduct.

Jan is recognised as a leading lawyer by: Best Lawyers 2017 – Corporate, 2013 – Mergers and Acquisitions (South Africa).

ALEXANDER VOGEL

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Alexander Vogel was admitted to the bar in Switzerland in 1992 and to the New York Bar in 1994. He holds a degree from the University of St Gallen Law School and a master’s from Northwestern University School of Law. He specialises in national and international mergers and acquisitions, acquisition finance, private equity, capital market as well as real estate transactions. His clients include listed companies as well as other large and medium-sized
companies. He is a member of the board of directors of several listed and private Swiss
companies, including companies active in the areas of financial services, technology, building
and real estate.

JAMES YONG WANG
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James Wang has 15 years of experience in the investment funds and asset and wealth
management field. He has represented international and Chinese fund clients in the
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funds, QFII and R-QFII funds, and QDII funds with total capital commitments in excess
of US$40 billion equivalent. He also regularly represents trust companies, broker-dealers,
mutual funds, insurance companies and wealth management companies in joint venture and
partnership transactions, M&A transactions and the structuring and issuance of various asset
and wealth management products. He has been consistently ranked as a ‘Leader in Investment
Funds, Private Equity and Venture Capital’ for China by Chambers, IFLR and Legalband.
He was also named as market leader for investment funds in China by the London-based
Legal Media Group’s Global Expert Guides for banking, finance and transactional law for
2015 and 2016 (the only lawyer at a PRC law firm named by the Global Expert Guides for
investment funds 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 it on PE secondary market initiatives. James is also active in PE and
VC investments, M&A and capital markets transactions. Prior to Han Kun, James worked
at several major international law firms in the US and China including Clifford Chance,
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RICHARD WATKINS
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Richard Watkins is a private funds partner in the London office of Kirkland & Ellis
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on private equity transactions including secondaries, spin-outs and mergers of private equity
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Private Funds and PLC’s Which Lawyer?.

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
Lexpert’s 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.

Significant clients include: Sun Capital, Oaktree Capital, Arlon Capital, Thoma Bravo, Genstar, Blue Point Capital, Nordic Capital, Novarits and Porsche Canada.

DAVID WIDGER
A&L Goodbody

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.

He is consistently recognised by clients and peers in leading international publications for his knowledge of the law and expertise in dealing with complex issues, including Chambers Global, Chambers Europe, The Legal 500, Best Lawyers, IFLR1000, PLC Which Lawyer? and Who’s Who Legal.

KLAUS HENRIK WIESE-HANSEN
Advokatfirmaet Steenstrup Stordrange DA

Klaus Henrik Wiese-Hansen is a partner at Steenstrup Stordrange and works in the firm’s banking and finance group. Mr Wiese-Hansen has 17 years’ experience in all areas of asset management, financial regulatory and capital markets legislation, including fund formation, fund management and alternative investments, as well as experience in private equity, including AIFMD regulatory advice. Mr Wiese-Hansen also has extensive knowledge and experience relating to company law and corporate M&A. He represents Norwegian and foreign institutional clients in all aspects of their businesses relating to the aforementioned legal areas. He is the author of several publications within his fields of expertise.

JOHN WILLIAMSON-NOBLE
Gilbert + Tobin

John Williamson-Noble is a partner in Australian law firm Gilbert + Tobin’s corporate advisory group and has been with the firm since 1995.

He has advised on many of Australia’s high-profile transactions. He has been recognised as a leading lawyer in corporate governance, capital markets, mergers and acquisitions, and private equity in a range of industry guides. He has advised on transactions that were, at the time, Australia’s largest successful merger – the merger of Westpac and St George Bank; Australia’s largest private equity deal – KKR’s acquisition of Brambles Australia; and Australia’s largest float – the IPO of Qantas.
He regularly advises on mergers and acquisition transactions, private equity deals and capital markets issues. He also regularly advises on corporate governance issues.

Mr Williamson-Noble is a member of the LPD Council of the International Bar Association (the world’s leading organisation of international lawyers) (IBA) and past chair of the IBA’s Corporate and M&A Committee. John is ranked by Chambers Asia-Pacific for equity capital markets and private equity and by IFLR1000 2014 as a leading lawyer in the area of mergers and acquisitions. John has also been recognised by Best Lawyers International since 2008 as a leading lawyer in equity capital markets, financial institutions, leveraged buyouts, mergers and acquisitions, private equity and venture capital, and was awarded Best Lawyers’ ‘Sydney Lawyer of the Year 2014-2015’ for leveraged buyouts. He has also been included in the Lawyer Monthly magazine’s Leading Lawyer Global 250 for 2014.
Appendix 2

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