TRAVERS SMITH

Investment Funds

Annual Update

There is little doubt that 2012 and 2013 is a period of significant change for the investment funds industry. There has understandably been a lot of attention given to the AIFM Directive, but there have been other developments that may have been overlooked, which will be of importance to fund managers, investors and participants in the alternative investment funds market. These developments include: recent case law on the relationship between GPs and LPs; regulatory changes in the US; marketing restrictions in the Middle East; and ongoing tax developments. In addition, this note will look ahead to some of the changes that can be expected over the next 12 months. Whoever said that change is as good as a rest?

Contents

PRIVATE FUNDS

Market overview

Challenging. That is about the most appropriate word to describe the conditions that almost all private funds in the alternative asset classes are facing, whether relating to fundraising, making investments, managing an existing portfolio or refinancing. In the context of fundraising, recent figures produced by Preqin indicate that the number of private equity funds closed during 2012 was at a near decade low and, despite three years already in the doldrums, the amount of capital raised in 2012 shows few signs of a recovery. This lack of fundraising activity is having knock-on effects. Some funds raised in the boom times are now reaching the end of their investment periods, but it is not a good environment to either realise investments or raise a new fund. To be able to keep doing deals, some managers are turning to deal-by-deal structures whilst others are developing managed account platforms supported by a smaller number of loyal followers. Investors are finding it difficult to recommit to funds because of a lack of liquidity and regulatory pressure being put on them to reduce expose to 'risky' asset classes. All of this is against a background of uncertainty as the industry tries to understand the changes being imposed by the lawmakers and regulators.

Despite the challenges, it should be noted that some asset classes are performing strongly in this environment. Infrastructure funds are faring well as investors seek stable returns; secondary funds are thriving on the opportunities being offered to them; and debt funds are responding to the financing gaps in the market. If there is another ray of sunshine, it is that by the end of 2013, we will have had five months to adjust to new Alternative Investment Fund Managers Directive regime and will, therefore, be a little step closer to stability.

Release of EVCA Handbook

In November 2012 the European Private Equity and Venture Capital Association (**EVCA**) released the EVCA Handbook - Professional Standards for the Private Equity and Venture Capital Industry. The Handbook integrates and replaces the EVCA Code of Conduct 2011, EVCA Governing Principles 2010 and the EVCA Corporate Governance Guidelines 2010 and brings together the key elements of governance, transparency and accountability that are expected of industry participants.

Compliance with the Code of Conduct (set out within the Handbook) is mandatory for all EVCA members and their affiliates. This Code of Conduct comprises six general principles and EVCA states that "a litmus test for application of these six principles is personal conviction that your actions would stand up to public scrutiny". There is further guidance to assist fund managers on the application of the Code of Conduct. Also, the Handbook confirms that compliance with IPEV's Reporting and Valuation Guidelines is required (see further below).

The Handbook will be formally reviewed on an annual basis and will be updated periodically to reflect industry developments (for example, it is likely that changes will need to be made to reflect the AIFM Directive). The Handbook is available to download from EVCA's website at http://www.evca.eu/about/default.aspx?id=504.

IPEV Reporting Guidelines

The International Private Equity and Venture Capital Valuation (**IPEV**) board issued the IPEV Investor Reporting Guidelines on 29 October 2012 in order to address the need for greater transparency, consistency and comparability in the methods used by general partners to report information to investors which is not typically included in accounting reports or statutory financial statements. The Guidelines were prepared with significant input from investors, general partners and service providers with the aim of providing a comprehensive and globally applicable set of disclosure principles. In particular, the Guidelines introduce 'essential disclosures' which general partners must include in fund reports distributed to investors, although IPEV have been mindful of the need for flexibility in such principles given the range of fund structures, asset classes and investment managers in the industry on a global scale.

Over the last few years, there has been an increasing focus on the form of communication between fund managers and investors. As well as the IPEV Guidelines, the Institutional Limited Partners Association (**ILPA**) has produced templates for investor reporting, capital call notices and distribution notices, while for real estate, INREV has also re-worked its reporting templates. In general, the fund management community has responded well to calls for greater transparency. It should also be noted that, with the AIFM Directive, there will be a further set of reporting requirements that European fund managers will have to consider and comply with.

IPEV also updated their Valuation Guidelines in December 2012, principally for the purpose of incorporating the 2011 'fair value' accounting changes to the IFRS and US GAAP accounting standards (and other bases of accounting using a similar definition of fair value). The updated Valuation Guidelines also provide definitive guidance on the application of fair value in the global private equity industry, including investments in early stage ventures, buyouts, infrastructure, mezzanine debt and similar investments in growth or development capital.

Both sets of Guidelines and further information can be found on the IPEV website at www.privateequityvaluation.com.

Case law update – disclosure of partnership information

The decision of the Chancery Division in the *Inversiones* case (*Inversiones Frieira SL and another v. Colyzeo Investors II LP and another* – May 2012) provided useful guidance on the level of information a limited partner is entitled to obtain in relation to a limited partnership structure and its underlying investments. Although ultimately deciding the case in favour of the general partner, the judgment reveals that the potential scope of the information open to inspection as "partnership books and records" can extend significantly beyond standard financial reports and material contracts to operational documents of the fund and, potentially, its SPVs.

The *Inversiones* case was brought by two affiliated investors in a European private equity real estate fund (structured as an English limited partnership) who were seeking an order for the GP to make available for inspection a vast amount of documentation relating to investments made by the fund and their underlying finance structure. The GP contested this went well beyond the scope of what a LP was entitled to review.

In addition to any contractual rights granted to LPs under the terms of the limited partnership agreement, the court considered a LP's statutory right "to inspect the books of the firm and examine into the state and prospects of the partnership business" under the Limited Partnerships Act 1907. This right to inspect the books is specifically framed by what is necessary for the purpose of allowing a limited partner to examine the state and prospects of the partnership business in which they have invested. While the extent of the "books of the Partnership" which are open to this right of inspection will vary on a case by case basis, the judge in the *Inversiones* case stated that: "if it would be necessary or advantageous for the GP or its delegate to rely on a document to establish rights as against a third party or to determine rights as between the members of the partnership themselves, then the document should be available for inspection by the LPs". This could potentially mean that, as well as the internal records of the partnership, a wide range of documents such as valuation reports and funding documents of a partnership will in principle be open for inspection. In addition, the judge indicated that if the GP or its delegate had obtained and held documents between third parties and such documents were significant for the partnership, they may also be regarded as part of the partnership books and records. This would mean that funding, operational and other transactional documents of underlying investment-level SPVs may also form part of the partnership books if it is the practice of the partnership to call for, examine or retain copies of such documents.

A limited partner's right to inspect partnership books will always have to be balanced alongside the fiduciary duties of the GP to act in the best interests of the partnership as a whole and the confidentiality provisions which the partnership may be bound by in documents to which it is party. The *Inversiones* decision does, however, serve as a timely reminder of the importance of agreeing appropriate investor reporting and confidentiality provisions with limited partners and determining the extent to which certain documentation should be retained at the SPV level.

Case law update – the Henderson PFI Secondary Fund II case

A recent decision of Mr Justice Cooke, involving an action by a group of 22 institutional investors against Henderson PFI Secondary Fund II over an alleged breach of mandate, provides useful guidance on the extent of the liability of fund managers and the law governing the liability of limited partners who becomes involved in the management activities of an English limited partnership.

In the case (*Certain Limited Partners in Henderson PFI Secondary Fund II LP (A Firm) v. (1) Henderson PFI Secondary Fund II LP (A Firm) (2) Henderson Equity Partners Limited (3) Henderson Equity Partners (GP) Ltd* – November

2012), a number of investors claimed that the manager and GP had used fund commitments to acquire a construction and project management company, John Laing plc, which included substantial assets falling outside the scope of the fund's investment policy. They claimed that the allocation of assets and liabilities to the fund was therefore unauthorised, based on grounds of breach of the management agreement and LPA and misstatements in the PPM.

The court considered whether limited partners could bring an action against both the GP and the manager and determined that while a general partner can be sued by any limited partner in respect of liabilities under its governing LPA (without such actions constituting management of the partnership business), any claim against a separate manager, for breach of a management agreement, is a 'partnership asset' and therefore must be brought by the GP, in the name of the Partnership. If limited partners pursued a claim against the manager, they would be standing in place of the GP, and would forfeit their limited liability for the period during which such claims are pursued, as this would constitute taking part in the management of the partnership business. In terms of general principles, the judgment indicates that as soon as there is participation in the decision-making process by requiring notice of individual decisions and commenting upon operational business decisions taken by the general partner, a limited partner will be 'involved in management'.

The general claim of the investors that the general partner/manager had acted in breach of the investment criteria was resolved in favour of the GP, on the basis that the investment policy specifically allowed for investment in assets which fell outside the investment policy within an initial commitment period and there was no basis for incorporating concepts from the PPM or proportionality in the size of PFI and non-PFI investments to qualify or over-ride this.

The *Henderson* case has a number of important lessons for both GPs/managers and investors. Despite ultimately finding in favour of the GP, fund managers should be re-examining the precise scope of their investment policies and governance regimes. Investors should also, when committing to funds, consider the legal relationship they have with both GPs and managers and carefully analyse the investment policy and investment restrictions of the fund.

LISTED FUNDS

PRIPs update

Over the course of 2012, various drafts of an EU regulation applying to "packaged retail investment products" were produced. It is expected that when the regulation comes into force (currently expected to be at the end of 2014), as well as for other retail products it will apply to closed-ended listed funds to the extent that they are marketed to retail investors.

The key obligation imposed by the regulation is for the "investment product manufacturer" to prepare and publish a key information document (**KID**) that is given to retail investors prior to their making an investment. Each KID will follow a standard form which summarises the key features and risks of the fund that is being marketed.

Similar proposals requiring the production of a KID were made at the time the amendments to the Prospectus Directive were consulted on. The proposals were dropped at that time in a move that was widely welcomed owing to the predicted difficulty in producing a KID for a listed fund (which is currently proposed to be not more than three pages long) that, on its own, allows an investor to take an informed investment decision on those securities. This concern remains, together with a lack of clarity as to who will be the investment product manufacturer for a listed fund that has appointed a third party manager. The KID will also require disclosure that is not consistent with the current market practice of the listed sector, for example each fund will need to be positioned on a "synthetic indicator" showing the risk and reward profile of its investment strategy.

In terms of liability, the latest proposal is that an investment product manufacturer will not incur any liability in respect of a KID unless it is misleading, inaccurate or inconsistent with any other binding contractual documents (which, in the case of listed funds, presumably means the prospectus to the extent one has been produced for a particular offer).

We will provide further updates once the final text of the regulation is published.

FSA proposal to restrict the promotion of certain investment products to retail investors

As noted in the "Regulatory" section below, the FSA has published a consultation paper that proposes an extension of the existing financial promotion rules which would mean that an authorised person could not make or approve a financial promotion to retail investors where the subject of that financial promotion is certain closed-ended listed offshore investment companies, VCTs or REITs. The proposed restriction would not apply to the promotion of UK investment trusts.

The proposal has not been welcomed by market participants for listed funds. It appears that the primary driver behind the changes is a failure by authorised persons to comply with the existing rules, leading many to conclude that a better solution would be more stringent enforcement of those rules rather than, in effect, excluding retail investors from certain asset classes.

In the event that the changes are implemented in the form proposed (final regulations are due to be published in March of this year), authorised managers and private client brokers are likely to need to change their current marketing practices for listed funds. For example, marketing of certain offshore listed funds by a private broker to its clients would need to be conducted through the forwarding of an issuer's prospectus under an anodyne covering email that does not attempt to summarise the terms of the prospectus. Further, it is likely that VCT managers would need to have separate websites for each of the funds they manage in order to take advantage of an existing exemption that allows a fund to market its own interests.

Our fuller briefing on the proposed rule changes can be found here.

New rules regarding prospectus summaries

The European Commission published amendments to the Prospectus Regulations which came in to force on 1 July 2012 in relation to the form and content of prospectus summaries. They apply to all prospectuses, including those for listed investment companies.

The new rules abolish the 2,500 word limit and instead prescribe that summaries must be no longer than seven percent of the length of the prospectus or 15 pages, whichever is longer.

The regulations set out a mandatory prospectus summary format and content requirements, redefining how we in the UK produce prospectus summaries. The rules are highly prescriptive. For example, the summary must be set out in a tabular format, be set out in a strict order and use certain prescribed headings. The content requirements are set out almost on a paragraph by paragraph basis.

The rules require the summary to describe concisely, in non-technical language, the key information relevant to the securities which are the subject of the prospectus. The summary must, when read in conjunction with the rest of the prospectus, aid investors considering whether to invest in the securities.

ESMA's guidance last year noted that information not prescribed to be included in the summary should still be included if it is key, e.g. summaries of specialist reports included in the prospectus. It also stated that there should be no extensive copying of text from the main body of the prospectus.

While there is still no separate civil liability for the summary, a person may be liable if the summary, when read in conjunction with the rest of the prospectus, does not provide key information.

Our precedent summary for an investment fund prospectus can be found here.

REGULATORY

The Alternative Investment Fund Managers Directive – countdown to implementation

There are only seven short months until the first cohort of fund managers must comply with the AIFM Directive. That cohort includes non-EU managers of non-EU funds intending to market into the EU from 22 July 2013, and EU managers who wish to be raising funds in the EU between 22 July 2013 and 22 July 2014.

On 19 December 2012, there were three important publications. Whilst not every point of uncertainty has been resolved by those publications, together they enable firms substantially to advance their planning. There is no guarantee that the remaining points of uncertainty will be clarified before the law comes into force, so firms are now forced to take a view, with expert advice.

Further, on 11 January 2013, HM Treasury published its consultation paper on how the Directive will be transposed into UK law. We will update clients on this separately. The consultation runs until 27 February 2013 and we will be working with the key industry bodies and trade associations in order to respond to this consultation. The consultation document can be downloaded from HM Treasury's website: http://www.hm-treasury.gov.uk/d/consult_transposition_of_the_alternative_investment_fund_managers_directive_110113.pdf.

We are the leading law firm advising alternative investment fund managers and service providers on the Directive, with expertise in its application to private equity, hedge, real estate, debt, infrastructure, fund of fund and long-only strategies.

Our commentary on the Level 2 Regulation, setting out the detailed rules for fund managers can be found here.

Our commentary on two consultation papers from the European Securities and Markets Authority, dealing with some of the Directive's "key concepts", including scope, can be found here.

Our summary of the current state of play for brokers of listed funds can be found here.

We provide bespoke seminars for senior management to enable them to understand what will be required. Please contact any of the partners listed at the end of this note for details.

Our previous publication on the Directive can be found here.

Details of our AIFMD team and the services we offer can be found here.

European Venture Capital Funds Regulation

The European Venture Capital Funds Regulation is essentially "AIFMD Lite" for EU venture capital (as opposed to private equity) fund managers. It allows EU managers to market EU qualifying venture capital funds to EU investors on the basis of a marketing passport, whilst imposing fewer and less onerous compliance obligations than with the AIFM Directive.

On 12 December 2012, the Cyprus Presidency of the EU Council announced that political agreement had finally been reached between the Council and the relevant European Parliament committees on the proposal for the Regulation (and an associated measure relating to Social Entrepreneurship Funds). The measure had been held up for several weeks by MEPs using it as a vehicle to attack structuring through certain "tax havens".

The Regulation is intended to come into force in parallel with the AIFM Directive from 22 July 2013, although it is unclear whether this timetable will be met.

The Regulation will take direct effect in EU Member States (not requiring any further domestic implementation, although there is provision for the European Commission to make harmonised detailed implementing rules).

The key features of the Regulation are as follows.

- It applies to EU managers of EU funds whose total AUM fall below the AIFM Directive threshold of €500m and whose funds are not leveraged.
- It applies generally to EU funds that invest at least 70% of their assets in equity or quasi-equity interests in Small and Medium Sized Enterprises (SMEs) i.e. companies with fewer than 250 employees and annual turnover not exceeding €50m or balance sheet not exceeding €43m.
- By contrast with the AIFM Directive, there is no requirement for the manager to maintain regulatory capital or liquid assets, and there is no need for a depositary to be appointed in relation to the fund.
- In an improvement on the AIFM Directive, the marketing passport allows for marketing to certain sophisticated investors who would be deemed "retail" for the purposes of the AIFM Directive.

Our fuller briefing note on the European Venture Capital Funds Regulation can be found here.

OTC derivatives market reform – The European Market Infrastructure Regulation

EMIR is the EU's legislative response to the G20 commitment to reform the OTC derivatives markets. EMIR will catch (amongst others) UCITS funds and those alternative investment funds (and their managers) that are soon to be subject to the AIFM Directive, in each case as regards their OTC derivatives trading activities. Such entities are "financial counterparties" for the purposes of EMIR and will therefore have to comply with EMIR's more onerous requirements as follows:

- *The clearing obligation* – i.e., the obligation to ensure that all standardised OTC derivatives, which are subject to a mandate of compulsory clearing from the European Commission, are cleared through a central counterparty.
- *The reporting obligation* – i.e., the obligation to ensure that all OTC derivatives (including non-centrally cleared transactions and market transactions) are reported to a trade repository.
- *The risk mitigation obligations* – i.e., a raft of detailed requirements in relation to risk mitigation that will apply in relation to all OTC derivatives that are not subject to the clearing obligation.

As an EU Regulation, EMIR takes direct effect in Member States without the need for domestic implementing legislation. EMIR entered into force on 16 August 2012, but is reliant upon a number of regulatory and/or implementing technical standards to be published by ESMA (amongst others). Elements of the regime will therefore take effect once the necessary technical standards have been finalized and take effect.

The first clearing obligations are likely to be in the fourth quarter of 2013. The reporting obligations for credit and interest rate derivatives are likely to start in July 2013 and for all other classes in January 2014.

However, the following risk mitigation obligations for all uncleared OTC derivative trades are likely to come into force much sooner than the clearing obligation and the reporting obligation:

- Timely confirmation of transactions – most likely March 2013.
- Reconciliation, portfolio compression, dispute resolution and reporting and mark-to-market / mark-to-models – most likely September 2013.
- Exchanging variation and initial margin – second half of 2013 at the earliest.

There will clearly be some significant market-wide implications, including the increased costs of compliance and the pricing of OTC derivatives, which will affect all alternative investment strategies.

Our fuller briefing on EMIR, published on 13 July 2012, can be found here.

Promoting unregulated funds to retail investors – FSA consultation paper

On 22 August 2012, the FSA published a Consultation Paper (CP 12/19) setting out its proposals to restrict the retail distribution of unregulated collective investment schemes (**UCIS**) and 'close substitutes' of UCIS (together, 'non-mainstream pooled investments' (**NMPIs**)). The consultation is in response to FSA findings which suggest that the majority of retail promotions and sales of UCIS do not meet the FSA's current requirements, thereby exposing ordinary retail investors to significant potential for detriment. The consultation also takes forward certain of the proposals contained in the FSA's Discussion Paper on Product Intervention, published in January 2011, where the possibility of restricting the marketing of certain products, such that they only reach customers for whom they are more likely to be suitable, was raised.

While the proposals appear to have been intended to restrict the distribution of products such as traded life policies and qualified investor schemes to "ordinary" retail investors, they are, at least as currently formulated, potentially much broader in scope, both in terms of the products subject to the restriction and the types of investors to whom certain in-scope products may be promoted. They may have ramifications for the broader funds industry.

A key issue is the very widely drawn definition of "NMPI", which will affect certain legitimate investment structures, such as VCTs, REITs and closed ended listed offshore investment companies. More details are set out in the "Listed Funds" section above.

A number of industry bodies and trade associations have submitted responses setting out their serious concerns about the FSA's proposals. The FSA intends to publish a Policy Statement summarising feedback received and setting out finalised rules and guidance in the first quarter of 2013. The changes would take effect some time after that.

Anti-financial crime – FSA thematic review of the asset management sector in H1 2013

The FSA has announced that it (or the successor Financial Conduct Authority) will conduct in the first half of 2013 a thematic review of anti-money laundering, financial sanctions and anti-bribery and corruption systems and controls within the asset management sector. This is one aspect of a greater focus on anti-financial crime with the transition to the new UK regulatory architecture.

The review follows similar work undertaken in relation to the systems and controls in place at banks. The FSA has made clear that it was disappointed with the results of that review and expects the asset management sector to do better. A speech by the FSA's director of Enforcement and Financial Crime, Tracey McDermott, outlining details of the proposed review, can be found here.

In particular, the FSA hopes firms will have taken into account its recently published guidance: "Financial crime: a guide for firms". The FSA badges this as a one-stop resource for firms considering best practice for dealing with anti-financial crime. The guide can be found here. In practice, firms should continue also to have close regard to the Joint Money Laundering Steering Group Guidance Notes and the Ministry of Justice guidelines on the Bribery Act 2010.

See also the information on changes to the Money Laundering Regulations 2007 set out in the "General Updates" section of this note.

Asset manager conflicts of interest – FSA "Dear CEO" letter

On 9 November 2012, the FSA published a paper about how asset management firms manage conflicts of interest. The FSA has required firms to consider the issues raised.

The Chief Executive of any firm who received the paper directly from the FSA in hard copy has been required by 28 February 2013 at the latest to provide a prescribed, formal attestation that his or her firm's conflicts arrangements are compliant. It is not clear on what basis such firms were selected.

Following urgent requests for clarification, the FSA updated its website to indicate that other asset management firms are not required to attest "at this stage". However, the FSA expects the senior management of all asset management firms to read and consider the letter, review their operations against it, and ensure their arrangements comply with FSA rules.

Our client briefing note on the "Dear CEO" letter (published before the FSA clarified its expectations of firms who did not receive the letter direct) can be found here.

TAX

General

For a government which emphasises tax simplification, the Coalition has introduced a lot of tax legislation. December 2012 saw the publication of draft rules for the 2013 budget with over 1,000 pages of text to absorb. In addition to these UK changes, investment funds will need to consider the tax impact of new law in other areas. The AIFM Directive is the main example of this: the readiness of different jurisdictions to implement AIFM Directive, the rules relating to remuneration and the AIFM Directive requirement that the fund manager is more than a 'letter-box entity' will all need to be factored into tax structures.

UK general anti-abuse rule

Tax avoidance moved to the top of the media's agenda in 2012 and, in response to HMRC's frustration at aggressive and widely sold tax schemes, the UK has confirmed that it will introduce a general anti-abuse rule (**GAAR**). The new rules will counteract arrangements if one of its main purposes is to obtain a tax advantage, but only if that advantage *"cannot reasonably be regarded as a reasonable course of action"* (sometimes referred to as the "double reasonableness test"). In interpreting what is reasonable, tax policy objectives, the existence of "contrived or abnormal steps" and/or the exploitation of "shortcomings" in the legislation will all be relevant. Rather unrealistically, taxpayers are meant to self-assess whether or not the GAAR applies with the help of published guidance from HMRC (the first draft of which was published in December 2012). It is to be hoped that HMRC uses the GAAR to focus on the aggressive end of tax avoidance schemes and not the centre-ground of tax planning, but – once the GAAR becomes law – mission-creep must be a real concern.

FATCA

It feels as if FATCA has been hanging over the industry for a long-time already, but it will start to become a reality in 2013. The UK government has entered into an Inter-governmental Agreement (**IGA**) with the US under which part of FATCA will be incorporated into UK law. UK investment funds will have to carry out due diligence in relation to their investors and report information to HMRC. Although the first report is not due until 31 March 2015, that report will cover 2013 and so investment funds need to incorporate information gathering powers into their investor documents if they have not already done so and will need to start compiling information about their investor base this year.

The Isle of Man, Channel Islands and the Cayman Islands have all announced their intention to enter into IGAs with the US, but had not done so at the time of writing. Funds based in non-IGA territories will need to enter into agreements directly with the US tax authorities if they want to avoid US withholding on payments made to them.

UK FATCA

Inspired by US efforts in this area, the UK has announced its intention to introduce "son-of-FATCA" which will require enhanced information gathering and reporting to HMRC by Channel Islands and Isle of Man financial institutions. Whilst the Isle of Man has agreed to the new approach, the Channel Islands have rebuffed the UK's demands, saying that they will not comply unless the new UK rules are applied globally. We will keep clients updated on developments.

Partnership Accounts Rules

Postponed from last year (and the year before that), it is likely that the Partnership Accounts (Amendment) Regulations will come into force from April 2013 and will require many English and Scottish limited partnerships to draw up GAAP/IFRS compliant accounts which must be filed at Companies House. Investment funds will need to consider what will become discloseable under the new rules and whether steps can be taken to mitigate their impact.

VAT

The UK government has been referred (along with Ireland, the Netherlands, Czech Republic, Finland, Sweden and Denmark) to the European Court of Justice for permitting dormant companies to join VAT groups. The European Commission had argued that only companies with 'economic activity' should be allowed to join a VAT group. In a welcome decision for groups and for private equity investment fund structures the Advocate General rejected the European Commission's argument: all eyes are now on whether the AG's approach is upheld in the judgment which is due to be delivered in early 2013.

Financial transactions tax

In late 2011, the European Commission introduced a draft Directive on a common system of financial transaction tax (**FTT**). The FTT has been identified as a source of EU budget financing that could ultimately replace contributions made by member states, thereby reducing the burden on national treasuries. The draft Directive provides that member states will need to implement or transpose the final Directive by the end of this year to commence on 1 January 2014. Currently the draft Directive is undergoing 'enhanced co-operation' procedures, and nothing substantive has yet been published.

UK tax returns: new on-line filing arrangements

Up until 31 January 2012, UK limited partnership funds were able to take advantage of 'special arrangements' for filing their UK partnership tax returns. The arrangements had been introduced as an interim measure to lessen the impact of HMRC's 2009 announcement that all partners (whether UK resident or not) in a UK partnership would be issued with a Unique Taxpayer Reference number (**UTRs**) to assist the partnership with its on-line filing obligations. The special arrangements included an extended paper filing deadline (31 January instead of 31 October) and the provision of internal reference numbers for non-UK resident partners in order to assist with the administration of filings within HMRC. Going forward, new arrangements for fiscal years commencing on 6 April 2011 require General Partners to access their investors' UTRs in order to file their returns on-line. HMRC will not release the investor's UTR without its authorisation. Such authority may already be provided under partnership documentation and, where a General Partner had already provided information about the investor under the special arrangements, it is likely that HMRC would release the UTR. There are however transitional arrangements for funds that are either not authorised to obtain the UTRs, or where there are other issues related to moving to on-line filing, which provide that (i) the process of allocating non-UK resident investors with internal reference numbers will continue, and (ii) the paper filing extension will remain until 31 January 2013.

And in other news...

The UK will have a statutory residence test for individuals from 2013. Internationally mobile executives will need to consider the number of days spent in the UK alongside other factors such as an available home and the location of their family.

Real estate funds focused on high-end residential property will want to look closely at the new rules designed to discourage 'residential wrappers' (offshore entities owning UK residential property). Last year saw the introduction of a new 15% SDLT rate and this year additional anti-avoidance measures will come into force imposing both an annual charge and capital gains tax on the disposal of the property by the non-resident owner. The good news is that there will be a carve-out from all the charges which should apply to most commercial property businesses (whether trading or investing). The bad news is that the exemption will not apply until the enactment of the 2013 Finance Bill in the summer: until then, the penal 15% SDLT rate will continue apply.

HMRC has amended two anti-avoidance measures (attribution of gains realised by non-UK close companies and the transfer of assets abroad rules) in an attempt to make them more EU compliant. The amendments provide exemptions for "economically significant activities", but these new carve-outs do not apply to investment businesses. There is a real question mark over whether the UK Government has gone far enough to ensure that these anti-avoidance measures do not impede EU freedoms – the general consensus is that the amendments do not go far enough.

INTERNATIONAL DEVELOPMENTS

Changes to German private placement laws from 22 July 2013

On 12 December 2012, the German government adopted a draft law to transpose the AIFM Directive into German law. The law goes further than is strictly necessary to implement the Directive. Amongst other things, it tightens up German private placement laws relating to unregulated investment funds.

Travers Smith cannot, of course, advise on German law. But we have been liaising closely with expert friends in Germany and would be delighted to arrange bespoke advice as required. While there are still some uncertainties, the following summarises the key private placement implications as we currently understand them for non-German managers marketing to German institutional investors.

From 22 July 2013, Germany will retain a private placement regime for marketing to professional investors undertaken by a non-EU entity which is regarded as the manager of a fund for the purposes of the AIFM Directive. (It is important to identify which entity is the manager for these purposes. There remain some open questions as to the extent to which marketing by other entities on behalf of the manager may be permissible).

Unless an EU manager of an EU fund markets on the basis of a passport under the AIFM Directive, the revised German private placement laws will apply. It appears that the passport will only be available to an EU manager from the point at which it is fully licensed under the AIFM Directive. The law does not explicitly deal with the position of an EU manager not yet entitled to the passport because it is relying on a transitional provision under the Directive. Such managers may not be able to market in Germany until they obtain their AIFM licence.

The "minimum harmonisation" requirements of the Directive which apply to marketing by non-EU managers under private placement regimes in any EU Member State will apply. These include the need for there to be supervisory cooperation agreements between the host Member State competent authority (BaFin in Germany) and the competent authorities in the jurisdiction of the manager and/or the fund, and compliance with minimum transparency obligations to prospective EU investors and EU regulators.

In addition, the following requirements will apply:

- appropriate precautions must be in place to prevent marketing to retail investors (German authorities may at some point give guidance as to the requirements here);
- the manager must appoint one or more bodies to perform the depositary functions required by the Directive for each fund marketed in Germany;
- a copy of the marketing materials must be sent to BaFin prior to being sent to potential investors in Germany. BaFin has between two and four months to confirm to the manager whether marketing is permitted. (It is possible that BaFin may object to certain types of funds being marketed in Germany but we do not know what criteria they may use; i.e. there is a risk that BaFin may refuse to grant authorisation for marketing and the third country AIFM should not assume that this will automatically be permitted). Marketing materials include a business plan, investment guidelines (LPA), name of the depositary, description of the fund; and "any other information on the fund made available to investors". Versions in English are acceptable.

If the fund being marketed is a non-EU feeder fund investing in non-EU master funds, this is permitted with no additional requirements (beyond those set out above).

If the fund being marketed is an EU feeder fund which invests in non-EU master funds, there are additional requirements.

The most significant issues which arise from this are:

(i) The lead-in time for BaFin clearance. We are awaiting publication of the UK rules on implementation of the Directive, but it is possible that the UK (along with other EU states) may also have a prior approval mechanism before marketing can take place under the UK "private placement" regime.

(ii) The depositary requirements. These are prescriptive and may not be met in full by many funds (EU or non-EU) under current structures. This may therefore affect the usefulness of the German regime.

Additional requirements apply to the marketing of funds to a new class of "semi-professional" investors and to retail investors.

SEC proposals: a relaxation of the prohibition on general solicitation

The Securities and Exchange Commission has recently put forward proposals (the **Proposals**) to implement certain changes mandated by Section 201 of the Jumpstart Our Business Startups Act of 2012 (the **JOBS Act**), which were designed to encourage the capital raising environment for small businesses by removing the prohibitions under the current US private offering regime on general solicitation and general advertising.

Currently, issuers, including private equity funds, are prohibited from making any general solicitation in connection with an offering of their securities unless those securities are registered with the SEC under the Securities Act. Rule 506 of Regulation D (which is generally the exemption relied on by private equity funds) provides an exemption from registration, provided that the issuer does not engage in any type of general solicitation.

The Proposals would remove the prohibition on general solicitation, provided that the issuer had taken reasonable steps to verify that all purchasers of the securities are accredited investors for the purposes of Regulation D and the issuer reasonably believed all of those investors to be accredited investors at the time of purchase.

The SEC has declined to set out specific verification methods that would be considered reasonable for the purposes of satisfying the exemption set out in the Proposals – instead issuers will need to consider the requirements on a case-by-case basis, taking into account developing market practices (such as the availability of data-bases of accredited investors). The SEC does though indicate that an issuer should have regard to the following factors:

- the type of purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- the nature of the offering – specifically: (i) the manner in which the purchaser was solicited to participate in the offering; and (ii) the terms of the offering, such as a minimum investment amount.

The SEC has acknowledged that many of the methods and practices currently used by issuers in their private offerings would meet the verification requirement – therefore it may in practice mean that issuers are not required to develop additional checks to satisfy the test. The Proposals will also not impact issuers who want to conduct private offerings under the existing regime without having to consider the verification process that making a general solicitation would entail. Similarly the exemptions from the Investment Company Act of 1940 which private equity funds traditionally rely on will not cease to be available simply because general solicitations are made under the amended Rule 506.

These amendments are likely to be helpful for private equity funds seeking to raise capital – historically the definition of "general solicitation" has been construed very widely and certain funds have had to suspend their fund-raising activities for a cooling off period where they have (often inadvertently) fallen foul of the restriction on general solicitation. The Proposals therefore remove a potential pitfall from the fund-raising process. The Proposals are expected to be implemented in 2013.

SEC registration – a reminder of the annual filing obligation

This time last year, we highlighted that one of the consequences of the US Dodd-Frank legislation was that many UK and European fund managers and advisers would need to register with, or make public filings with, the SEC. A number of exemptions from registration are available, including the Foreign Private Adviser exemption, the Private Fund Adviser exemption and the Venture Capital Fund exemption.

The latter two exemptions required firms to make public filings with the SEC before 30 March 2012 by submitting a Form ADV. It is important for firms who have made filings to remember that the filing obligation is an annual one (generally within 90 days of the firm's year end).

Marketing funds in the Middle East

In August 2012, the final form of new rules came into force in the United Arab Emirates that impose tougher restrictions on the marketing of foreign funds. This is further evidence of a tightening of rules in the Middle East in response to the losses suffered by Middle Eastern investors during the global financial crisis: marketing foreign funds in Saudi Arabia has been a challenge for a number of years, but in 2010 new rules were introduced in Kuwait and now the important jurisdiction of the UAE has followed a similar path.

Under the new rules in the UAE, the marketing of a non-domestic fund requires the use of a locally licensed promoter, such as a local bank or investment company. The local promoter must also obtain the approval of the UAE's regulator, the Securities and Commodities Authority (**SCA**). There is an exemption from needing a local promoter if only institutional investors are being targeted and each investor will commit the equivalent of at least €2.1m. However, this exemption still requires the foreign fund manager to promote its own fund through its own local representative office and still requires the prior approval of the SCA.

A recent public meeting organised by the SCA has provided a few crumbs of comfort. At the meeting, the SCA suggested that the new regulations were not meant to capture 'reverse solicitation' based on previous dealings or a pre-existing relationship. They also stated that marketing through a representative office of a placement agent would be sufficient, rather than the fund manager having to set up its own local office. Whilst these interpretations are helpful, they do not appear to be binding on the SCA, so caution will still need to be exercised when marketing in a foreign fund in the UAE and more generally throughout the Middle East.

Changing CFTC regulations affecting private funds

During 2012, a number of changes to laws and rules in the US now mean that private funds (including private equity and real estate) with US investors will need to consider whether they should register with the US Commodities Futures Trading Commission (**CFTC**).

It has been a long-standing requirement that managers and GPs of funds that trade 'commodity interests' (or that invest in other funds that trade commodity interests), are required to register with the CFTC as a commodity pool operator, unless they qualify for an applicable exemption. As a result of changes made by the Dodd-Frank Act, the definition of what constitutes a "commodity interest" has been expanded so that it now includes swaps, and the definition of a 'swap' is drawn widely. In addition, an exemption from registration that was commonly-used by private funds (the exemption being that effectively all investors in the fund are 'accredited investors') has been repealed with effect from 31 December 2012.

However, in November the Treasury Department issued a final written determination exempting both foreign exchange forward contracts and foreign exchange swaps from the definition of a 'swap'. As a result, managers and GPs of private funds that trade FX forwards and/or FX swaps but do not trade other swaps or instruments that qualify as commodity interests for CFTC's purposes will no longer be required to register with the CFTC.

If a manager or GP of a private fund with US investors does trade swaps subject to CFTC jurisdiction, it is still possible that the *de minimis* exemption will apply. In order to qualify for this exemption either (i) the aggregate initial margin and premiums for all commodity interest positions held by the fund must not exceed 5% of the liquidation value of the fund's portfolio or (ii) the aggregate net notional value of all commodity interests positions held by the fund must not exceed 100% of the liquidation value of the fund's portfolio (in each case including any unrealised profits and losses on open positions). Because of the final written determination of the Treasury Department referred to above, managers and GPs may now exclude FX forwards and FX swaps from their calculation under the *de minimis* exemption. If the exemption does apply, there is a simple notification that needs to be filed with the CFTC on an annual basis and notice needs to be provided to investors in the fund.

GENERAL UPDATES

Fund Finance update

In the context of the AIFM Directive, the recently published Level 2 Regulation provides guidance on what will constitute 'leverage' of a fund and how it will be calculated. Private equity and real estate funds will prefer to be regarded as unleveraged for the purposes of the AIFM Directive, either to remain out of scope or to avoid the additional compliance and reporting obligations that apply to managers of leveraged funds. The Level 2 Regulation provides that borrowing arrangements which are temporary in nature and are fully covered by the commitments of investors in the fund are not to be treated as leverage. Whilst at first glance this would appear to exclude investor call bridge facilities, the Regulation goes on to say that revolving credit facilities should not be considered as being temporary in nature. Given that almost all investor call bridge facilities are structured as revolving credit facilities, there is now some uncertainty around whether a fund's investor call bridge facility should in fact be treated as leverage. In our view, a traditional investor call bridge facility which is genuinely used to bridge the requirement to call for capital from investors and which is repaid on a regular basis – whether through capital calls from investors or the realisation of fund assets – should not be treated as leverage for these purposes. Through our work with the trade associations, we will be seeking to secure guidance to that effect from regulators. If there is no such guidance, firms will need to consider their arrangements carefully on a case-by-case basis.

As a general update on bridge financing arrangements, we are seeing a wide range of security packages being taken by the lenders. As usual, this is determined by factors which are either deal specific (for example, underlying analysis of investors) or market specific (for example, lending appetite amongst debt providers). The range of different security packages may be summarised as follows:

- No security: only the strongest credits or the smallest deals will achieve this;
- Power of Attorney only: again unusual on the basis that if security is to be granted, the lender will typically look for a more "watertight" package, but still a possibility;
- Security Assignment (without specific acknowledgement from investors) and LP drawdown account security: probably the most common (taking into account the factors mentioned above); and
- Security Assignment (with specific acknowledgement from investors) and LP drawdown account security: less common given that the Fund will resist the requirement for LPs to acknowledge, but still a possibility.

The CRC Energy Efficiency Scheme (CRC)

In December 2012, the Government at last confirmed its proposals for simplifying this ambitious piece of climate change legislation. Contrary to speculation, the CRC will not be scrapped and replaced with a straight carbon tax, although it will be reviewed again in 2016.

In summary, most of the proposals made in the earlier consultation paper were widely supported and will be implemented in full. Although we will be producing a more detailed client briefing on the recasting of the CRC shortly, we thought it worth highlighting the following changes which will be of particular relevance to funds and more complex corporate structures:

- There will be greater flexibility for disaggregation, to allow organisations to separate out into natural business units for compliance and reporting purposes. This change will be welcomed by the private equity industry as it should make it easier to disaggregate portfolio groups so that each group can participate on its own, irrespective of its energy usage. Disaggregation will require the mutual consent of the parent undertaking and the disaggregated entity.
- The rules relating to designated changes within an organisation (i.e. large acquisitions and disposals) will be simplified. The deadline for registering those changes will also be extended from 3 months from the date of the transaction to the last working day of April of the compliance year following the transaction.
- The rules relating to the treatment of trusts holding real property will be clarified.

Most of the above changes will be implemented with effect from 2014, at the start of Phase 2 of the scheme. However, some of the changes (for example, the reduction in the number of fuels covered by the scheme) will be implemented from 1 April 2013.

The Government response to the consultation on simplifying the CRC Energy Efficiency Scheme can be accessed at here.

The rise of Environmental, Social and Governance (ESG)

As demonstrated in both the IPEV Reporting Guidelines and EVCA Handbook, environmental, social and governance performance, management and reporting issues (whether under the banners of responsible investment, ESG, sustainability, corporate social responsibility, etc) are appearing higher on the agenda of businesses.

Although prompted in part by developments in the UK, EU and international legislation (including the UK's Bribery Act 2010 and new carbon reporting rules), these changes are largely being driven by institutional investors, shareholders and customers. In addition to these drivers, recent case law also points to a harsher, less forgiving approach to enforcement as well as increasingly substantial fines and damages for regulatory non-compliance and failings in relation to ESG type issues. Notably, the English courts have recently shown a willingness to circumvent the corporate veil and find parent companies liable for the safety breaches of their subsidiaries.

Our recent work providing legal support to members of the UK delegation at the UN's Rio+20 conference demonstrated, if nothing else, that companies will need to be more transparent about how they perform in relation to a range of environmental, climate change, social and governance indicators. Failure to do so may not only damage reputations and give rise to legal liabilities, but also limit funding and investment opportunities. It is also becoming increasingly clear that simply making general and often aspirational policy statements will no longer suffice.

As a first step, time should be spent understanding how ESG type issues might be of relevance. Robust policies and procedures should then be developed and implemented (in particular, in relation to the reporting of performance). Care will also need to be taken when diligincing investment opportunities as well as ensuring both the funding and equity documents provide sufficient powers and flexibility.

Changes to the Money Laundering Regulations 2007

On 17 July 2012, HM Treasury published the government response to the 2011 consultation on proposed changes to the Money Laundering Regulations 2007 (the **MLRs**). A number of changes to the MLRs came into force on 1 October 2012, only a few of which are likely to have a direct impact on the AML procedures within private equity or real estate firms.

The following changes should be noted:

- under the old regulations, an enforcement officer had the power to require relevant persons (i.e. persons to whom the MLRs apply, such as credit institutions, financial institutions, auditors, insolvency practitioners, external accountants and tax advisers) and their connected persons to provide information or attend an interview. Regulation 37(2) has now been amended to further define a "relevant person" as including a person whom the FSA (or other designated authority) believes, or has reasonable grounds to suspect, is or has at any time been a relevant person; and
- under the old regulations, the MLRs conferred wide powers on a designated authority to impose unlimited penalties on a relevant person who failed to comply with specified provisions of the MLRs. Regulation 42 has now been amended to give the FSA (or other designated authority) the power to impose a penalty on a person who fails to provide information or attend an interview if requested by an enforcement officer under Regulation 37(1).

A further change which has not yet come into force is that firms will be required to keep records of the identity of beneficial owners as well as customers. The Government has mentioned that this change will form part of a wider package of regulatory changes which will result from the revisions to the EU Third Money Laundering Directive expected in 2013.

The final Money Laundering (Amendment) Regulations 2012 are available here.

For further information on the issues set out in this briefing note, please contact one of the partners in our Investment Funds Group or your usual contact at Travers Smith. Contact details are set out below.

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