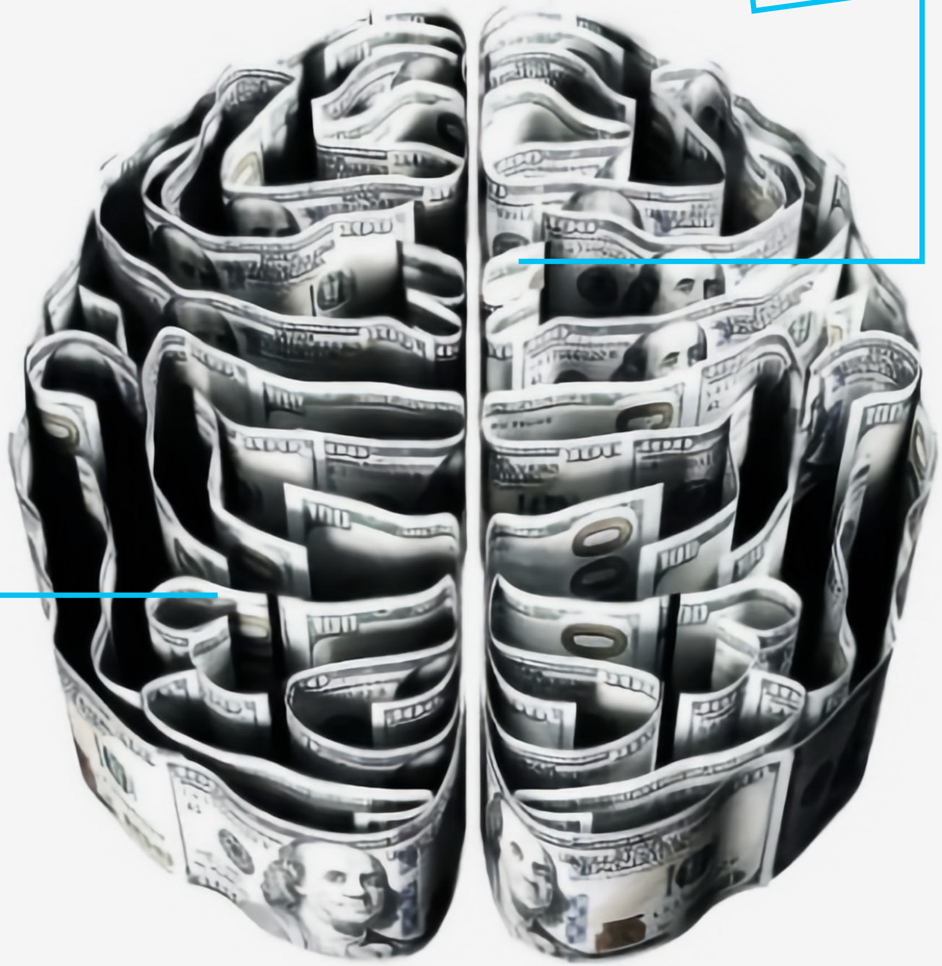
TOPICAL ISSUES FOR
PE FUND MANAGERS

EVERYTHING BUT THE DEAL



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ADDLESHAW GODDARD

HEADING INTO THE AUTUMN IT SEEMS LIKELY THAT DEAL ACTIVITY LEVELS WILL REMAIN BUOYANT...

For many years there has been a growing commentary around how the UK has taken a more continental approach to summer breaks, with relatively little deal activity during August, but that wasn't really our experience this year. Whether due to the changing trends of agile working in response to COVID, or in anticipation of a very busy Q4 for deals (which seems to be the confident prediction of almost all stakeholders we talk to), our own activity levels remained relatively high as deal-doers ran at processes throughout the summer with closings in August or early September, compared to the usual "back to school" period that our lawyers typically experience after a slightly less intense month or so.

The Autumn edition of EBTD offers a real mixed bag of content. We have our usual reflections on the latest tax developments, and a very helpful overview of the new International Data Transfer Standard Clauses which are starting to work their way into our due diligence reports.

ESG continues to dominate the agenda in our world in various ways, and I don't recall an issue of EBTD where it hasn't featured in some shape or form, with a continuous stream of regulation, and the FCA continuing to involve themselves in the debate. We have spoken to a number of GPs, LPs and other stakeholders on the topic (you can see details of how to access our report on page 11), and in addition to that I've personally heard or read the views of a number of our private equity clients as part of our client feedback programme. Despite some of those investors appearing quite similar in their nature and market position, we nevertheless do hear a range of perspectives on ESG – and whilst none would deny the importance of ESG in their world, some are proactively looking to differentiate themselves as "best in class" at one extreme, whilst others might prefer to reflect on good ESG being "what they have always done" on the other. Irrespective of the camp you are in, navigating the ongoing tsunami of regulation will be a challenge, so do look out for the timeline that our team is putting together to help you understand the different requirements.

As an adviser on downstream investment work myself I've seen my fair share of overperformance and underperformance on an asset by asset basis, but have perhaps not always had a full appreciation of the dynamics this can create at fund level. Apart from the obvious individual company challenges that COVID has created, there will no doubt also be wider portfolio dynamics for many investors, with original timelines for the full realisations of portfolios being thrown out of kilter. Our Funds Finance team see the full range of financing solutions available in the market, and personally I found their article (see page 22) a very accessible overview of some of the solutions available. A bespoke solution to any particular portfolio's characteristics is clearly paramount here, so if you would like to talk to us about the different options that are available please do get in touch.

As always our focus remains on providing content which is topical and relevant to our investor clients, so if there are other areas you would like to see us cover in future editions please do let us know. Enjoy the busy Q4 we've all been promised!

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THE BIG PICTURE

It was a fairly quiet summer, from a tax perspective. Unlike deal-doers and professional advisers, who have seen no let-up in transactional activity this calendar year, the Treasury and HM Revenue & Customs had a decent summer break, it seems. The main flurry of excitement was around the mid-summer publication of draft legislation in relation to asset holding companies owned by alternative funds: the first part of the Government's wider review of the UK funds regime.

What's prompted the review? The usual culprit - Brexit - and the desire to entice asset management back to the UK, away from European competitor jurisdictions. The new regime, clearly of relevance to the PE world, is the subject of our deep dive this month, in 'Tax at Stake' over the page.

Apart from that, not a lot to report of particular relevance to private equity. Worth mentioning, though, is the recent (long-trailed) announcement of a UK-wide 1.25% Health and Social Care Levy based on National Insurance contributions and ring-fenced to fund investment in health and social care. The Levy will start out in the form of a temporary 1.25% increase to NICs (so not applicable to those over state pension age), lasting for the 2022–23 tax year only. But then from 6 April 2023, the tax will metamorphose into a new 1.25% Health and Social Care Levy (which will apply to all working adults above state pension age), with NICs rates returning to 'normal'.

The Levy will be administered by HMRC and collected via PAYE and income tax self-assessment.

The Government will also legislate in the next Finance Bill to increase the tax rates paid by individuals on **company dividends** by 1.25%, from April 2022, to stave off some early (pre-emptive) criticism that investor fat cats were being let off, whilst hardworking middle earners are forced again to dip into their pockets...

And finally, the date of the autumn statement has been announced – 27 October – which means we start another (the third?) round of speculation about whether Capital Gains Tax rates will increase and/or the CGT regime will be radically overhauled.

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TAX AT STAKE

QAHCS - LAME DUCK OR GOLDEN GOOSE?

In July, the Government issued draft legislation introducing a new regime for asset holding companies **(AHCs)** owned by alternative funds. Seen by the Government as an initial step of its wider review of the UK funds regime, it aims to compete with current jurisdictions of choice, such as Luxembourg.

WHY ALL THE FUSS?

As the Government's first consultation document on the topic back in March 2020 noted, the UK asset management sector is the largest in Europe, and the second largest globally, making "an invaluable contribution to the UK economy". Rightly, the Government is committed to the ongoing success of the asset management industry and isn't going to take any chances with it post-Brexit.

Whilst attracting AHCs to the UK may result in job creation down the line, the main rationale for change is probably more closely aligned with the motivation for the wider funds review. Responses to the initial consultation noted that funds often seek to locate AHCs in the same jurisdiction as the fund vehicle, thereby avoiding the need to consider multiple regimes, facilitating sharing of staff and service providers and ensuring that AHCs have a non-tax principal purpose to support claiming of double tax treaty benefits. In other words, we shouldn't assume that funds will keep asset management functions in the UK when there may be benefits to aligning fund and AHCs jurisdictions (and when other jurisdictions offer better outcomes for AHCs).

WHAT WILL THE NEW REGIME LOOK LIKE?

The new regime will be an elective one, effective for the tax year 2022-23 onwards and applying to certain UK resident companies – referred to in the legislation as qualifying asset holding companies or “QAHCs” – that are at least 70% owned by Category A investors (diversely-owned, eligible funds, certain institutional investors (sovereign wealth funds, pension schemes, long-term insurance businesses, charities and REITs), other QAHCs and Ministers of the Crown). To be a QAHC, a company must have a main activity of investing its funds with a view to spreading investment risk and giving investors the benefit of the management of its funds and no other activities to any substantial extent. QAHCs cannot be REITs or listed. Fund eligibility will be based on CIS or AIF rules, with a genuine diversity of ownership test similar to that used in the UK’s offshore funds rules or, for companies, a ‘non-close’ concept similar to that seen in the UK’s NRCGT rules.

The stated aim is to remove barriers to the establishment of QAHCs in the UK, to tax QAHCs at a level “commensurate with their role” and to ensure that UK investors are taxed as far as possible as if they had invested directly in the QAHC’s underlying assets. Are funds really going to move their asset holding companies to the UK? Probably not, but they might give serious thought to locating any new ones they establish there.

The main framework is now drawn but much remains to be spelled out that could impact the success or failure of the new regime. Key factors for funds weighing up the UK against other locations will be simplicity, stability and levels of red tape.

WHICH ASPECTS OF THE REGIME ARE LIKELY TO BE MOST BENEFICIAL FOR PRIVATE EQUITY FUNDS?

The switching off of withholding from interest paid by QAHCs to investors, the ability to deduct results-dependent interest paid by QAHCs to investors and the switching off of rules that delay deductions for interest payments until the interest is actually paid (as opposed to when it is accrued) are all likely to make funding of acquisitions and provision of follow-on funding easier. On portfolio company acquisitions, we will probably continue to see multiple newco structures as some of the reasons for having separate newcos (including the need for structural subordination of junior and mezzanine debt) will remain relevant. On exit, the exempting of gains (on most types of shares and also on overseas real estate) coupled with rules enabling QAHCs to deliver a capital return to investors through a repurchase of their shares (and related stamp duty relief) may facilitate sales at portfolio company level.

ARE THERE ANY POTENTIAL PITFALLS?

Meeting and maintaining the 70% Category A investor requirement will be key. Care will be needed with 'side pocket' investments because if a QAHC issues securities entitling holders to a particular sub-class of assets, the 70% test will also need to be met by reference to that sub-class of securities.

People sharing in the results of investment assets (including lenders receiving a variable rate of return) will count as investors whereas people making plain vanilla loans won't - will this provoke a change in debt composition? In any event, funds will need to keep an eye on types of funding used and their impact on QAHC status.

Working out how to accommodate investors that aren't Category A investors (referred to in consultation feedback and in this article as Category B investors) will also be important. Government feedback noted that carried interest entitlements in a fund which is an investor in an AHC will not be relevant to the 70% calculation if that fund is a Category A investor. However, individual fund managers with direct interests in the AHC (or interests in the AHC held via a collective vehicle such as a carried interest partnership) will be Category B investors, whether those interests are in the nature of carried interest or co-investment. In determining ownership proportions, carried interest holders will be assumed to hold their maximum eventual share of profits at all times (to avoid catch-up rights distorting the position when hurdles are met).

Provisions enabling AHCs to deliver a capital return to investors may also create tension if a combination of regime rules and 'normal' UK tax rules effectively singles out management for income tax treatment on a share buyback by a QAHC.

WHAT ARE THE KNOWN UNKNOWNS AT THIS STAGE?

Achieving a level of tax "commensurate with the QAHC's role" will not be a precise science – and is to be the subject of HMRC guidance about how to apply transfer pricing rules and principles in this context. That guidance will need to be clear and unequivocal in order to give funds confidence in predictable tax outcomes.

The Government is keen to ensure that the regime does not create scope for avoidance, enable regime reliefs or stockpiled losses of QAHCs to be used in non-qualifying business, alter the tax take from UK real estate or result in different outcomes for UK investors as compared with a direct investment in underlying assets. It is also keen to understand the impact of the regime once up and running. Understandable concerns – but a light touch will be needed here. Legislative detail is awaited on various fronts and should not be allowed to detract from the attractiveness of the regime.

SHOULD FUNDS BE LOOKING AT THE UK WHEN DECIDING WHERE TO LOCATE AHCS IN FUTURE THEN?

Absolutely. The regime is shaping up well following two rounds of Government consultation and there is ongoing commitment to maintaining an open dialogue with participants in and advisers to the fund industry as the rules are finalised.

As long as rules dealing with entry to and exit from the regime, breaches of qualifying conditions, anti-avoidance and compliance are kept relatively simple, the regime promises a tax-efficient framework for asset-holding companies, designed with the broad aim in mind that, as far as possible, investors do not suffer tax over and above the tax they would have borne had they invested directly in the underlying assets.

The fact that careful consideration is being given to facilitating the holding of UK and overseas real estate and ensuring the regime works in tandem with the UK's REIT regime is also a real positive for funds looking to hold a variety of eggs in one basket. (QAHCK QAHCK).

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2 REGULATORY DEVELOPMENTS

ITS NOT EASY BEING GREEN...

"It's not easy being green" sang Kermit the frog. Fund managers trying to keep up with the avalanche of Environmental Social Governance **(ESG)** regulation can be forgiven for feeling the same! With the scope of regulation ever increasing, and the "S" part of ESG rising in importance to equal "E", a reprieve in the near future is unlikely.

DISCLOSURE REMAINS THE NAME OF THE GAME

Much of the ESG regulation currently affecting fund managers is disclosure focused. The majority of the of the action and policy setting has, to date, happened in Europe, with the EU's Sustainable Finance Reporting and Disclosure **(SFDR)** regulations having started to apply from March 10th this year. This legislation affects UK fund managers wishing to market their funds in the EU or, albeit more indirectly, providing portfolio management services to EU domiciled funds.

Contrary to what many had expected, the UK chose not to on-shore the SFDR regulations into UK domestic law. Instead, it is charting out its own course when it comes to ESG regulation of UK fund managers, firmly focused, for now, on the "E" side of ESG.

THE FINANCIAL AUTHORITY (FCA) TASKFORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD)

Enter the long awaited FCA consultation paper - CP21/17, setting out the FCA's proposals for new climate-related disclosure requirements for asset managers, life insurers and FCA-regulated pension providers. The proposals had been widely dubbed as the UK's SFDR before they landed, but there are material differences.

WHO'S IN SCOPE?

Many UK PE fund managers will find themselves in the scope of the FCA's SFDR rules because they are Alternative Investment Fund Managers **(AIFM)** managing private funds or providing portfolio management services to funds (and other clients, for example under Special Memorandum Accounts **(SMAs)**).

Importantly, "portfolio management" for these purposes will also include investment advice when performed as part of "private equity activities". An important exception is that fund managers with Assets Under Management **(AUM)** of less than £5 billion (calculated on a three year rolling average) will not be in scope. It remains to be seen how that exception will apply, as the consultation paper does not offer a methodology for calculating AUM. Interestingly, the FCA and Her Majesty's Treasury **(HMT)** consider that the vast majority of the UK's asset management sector will be covered by the rules.

Non-UK fund managers (including US and EU AIFMs) that market their funds into the UK under the UK's national private placement regime, will not be in-scope either, drawing a contrast to the application of the EU SFDR to those non-EU fund managers that look to raise capital in Europe.

WHAT'S INVOLVED?

Broadly speaking, the proposed rules will see asset managers having to make annual entity-level and product-level disclosures (via websites and client communications) which are aligned to the TFCD recommendations, supplemented by some additional metrics. Some useful flexibilities are being proposed too, such as the ability to make "group level" disclosures or, particularly relevant in the context of private equity funds, the ability to make product level disclosures available to Limited Partnerships **(LPs)** on demand rather than publicly on a website.

The FCA will consider responses to its consultation in the coming weeks and is expected to issue final rules before the end of the year. The final rules may start applying to the largest fund managers from 1 January 2022, with the bulk of fund managers in the UK anticipated to come into scope a year later.

ENTITY-LEVEL DISCLOSURES, PRODUCT-LEVEL DISCLOSURES... SOUND FAMILIAR?

On the face of it, there are some broad similarities with the EU's SFDR regime and many UK fund managers in scope of SFDR (by virtue of raising capital in Europe) may have hoped for some broad alignment. Alas, whilst there are overlaps, there are also significant divergences, for example around different/additional calculation methodologies under the UK regime, and also by virtue of the fact the UK regime, for now, will focus "just" on climate risk. For many UK fund managers, the adoption of the FCA rules would mean dual compliance regimes.

ANOTHER LETTER FROM THE FCA

It has been a busy summer for the FCA when it comes to ESG. The regulator also found time to pen a letter to chairs of authorised fund managers, regarding poorly drafted applications of ESG focused investment funds. The letter set out its expectations (through a set of guiding principles) around fund design, disclosure and ongoing monitoring of holdings, in respect of funds that are being promoted as sustainable investment funds. Whilst the letter focused on retail funds rather than private funds, inevitably there will be some read across in terms of the overarching expectations that the FCA has of authorised firms generally.

The FCA's 2021-22 Business Plan also highlights wider initiatives outside of its own TCFD work, including increased supervision to check that asset managers' ESG investment product attributes are fair, clear and not misleading. Sitting in the background is the continuation of the government's roll out of its Green Finance Strategy, including a UK green taxonomy. A topic for another day!

LOSING TRACK?

To bring it back to puppets, it does at times seem that only a Count von Count can keep up with the ever increasing number of ESG regulations. To help you, we have developed an interactive timeline setting out the key developments in ESG regulation in the UK and the EU, broken down by application to asset managers, banks, pension funds, building societies and corporates. We will provide more information on this soon.

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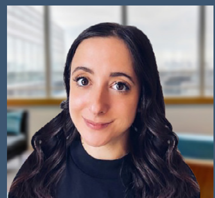

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PRIVATE FUNDS MAKING AN IMPACT IN AN ESG WORLD

PRIVATE FUNDS MARKET INSIGHTS 2021

We have recently spoken to GPs (both institutional asset managers and specialist fund managers), LPs (including pension funds and funds of funds), lenders in the funds finance market and other key stakeholders in the private funds world, covering a broad spectrum of investment strategies and sectors – from real estate and infrastructure to renewables, social impact and core private equity.

These stakeholders have kindly shared some key insights relating to the challenges and opportunities that the heightened focus on ESG has brought in the investment space.

Click here to read more.

RAISING CAPITAL IN EUROPE

WHAT DO RECENT CHANGES TO THE EU'S CROSS-BORDER FUND DISTRIBUTION RULES MEAN FOR NON-EU FUND MANAGERS?

Eagle-eyed and seasoned readers of EBTD will recall that just over a year ago we covered the new rules amending the EU's framework for the cross-border distribution of funds (see our previous article here).

Fast-forward a year and key parts of the new rules, set out in a Directive and a Regulation, have now started to apply with effect from 2 August 2021, amending, in part, the Alternative Investment Fund Managers Directive **(AIFMD)** marketing framework as it applies to EU fund managers.

Earlier this year, this legislative package was further complemented by a set of Guidelines issued by the European Securities and Markets Authority **(ESMA)**, setting out specific detailed requirements for marketing communications. The Guidelines will apply from early 2022.

To recap, key changes under the Directive and Regulation include:

- A definition of "pre-marketing" and expressly permitting pre-marketing to professional investors, subject to certain conditions (such as making a pre-marketing notification in an EU AIFMs home Member State).
- Restricting the ability of EU AIFMs to rely on reverse solicitation in any instances where a fund has been notified for pre-marketing.
- Introducing additional requirements on marketing communications (which under the Guidelines will include the PPM, pitch books and some social media content), including presentation of information, risk factors and rubrics.

HOW WILL NON-EU AIFMS BE IMPACTED BY THE NEW RULES?

On the face of it, the new rules are applicable to EU AIFMs rather than non-EU AIFMs (which, after Brexit, now of course also includes UK PE fund managers).

Nevertheless, non-EU fund managers are likely to be impacted in a number of ways.

NON-EU FUND MANAGERS OPERATING UNDER A DELEGATION MODEL

It has become a well-trodden path for some non-EU fund managers to provide their fund management services under a delegation model, whereby either a third party (host) EU AIFM or a locally authorised EU subsidiary of the non-EU manager performs the EU AIFM role, and then delegates portfolio

UNDER THE NEW RULES ONLY CERTAIN TYPES OF ENTITIES WILL BE ALLOWED TO CONDUCT PRE-MARKETING ACTIVITIES ON BEHALF OF AN EU AIFM.

management and certain other services (often including fund marketing related activities) back to the non-EU fund manager.

In these arrangements, going forward, the EU AIFM will be directly in scope of the new rules.

This matters, because under the new rules only certain types of entities will be allowed to conduct pre-marketing activities on behalf of an EU AIFM. These entities are Markets in Financial Instruments Directive **(MiFID)** investment firms and tied agents, EU credit institutions, Undertakings for Collective Investment in Transferable Securities **(UCITS)** management companies and EU AIFMs.

This may make it more difficult for a non-EU fund manager (in their role as sub-delegate of the EU AIFM) to engage in pre-marketing activities. How significant this will turn out to be in practice remains to be seen. Even before the new rules came in, several EU Member States took a restrictive view of the scope of marketing-related activities that non-EU entities could perform in their territory without a local licence.

MARKETING BY NON-EU AIFMS UNDER NATIONAL PRIVATE PLACEMENT REGIMES (NPPRS)

Whilst the new rules are expressed to apply to EU AIFMs, the Directive had to be implemented through national legislation and it was (and still remains) open to each EU Member State to "gold plate" the requirements under the Directive, and hence extend their application to non-EU AIFMs.

Therefore, we are likely to see an inconsistent approach across EU Member States.

For example, Germany will extend the application of the key parts of the Directive (including pre-marketing notification requirements and restrictions on reverse solicitation as these are set out in the Directive) to non-EU AIFMs marketing under NPPRs in Germany. France, on the other hand, for now will not do so.

The rules applicable to marketing communications are set out in the Regulation which is directly applicable and does not depend on further national implementing legislation. The Guidelines sit under the Regulation. Therefore, the new rules on marketing communications are only applicable to EU AIFMs. That said, it is open to individual regulators in EU Member States to issue corresponding rules and guidelines applicable to non-EU AIFMs marketing funds in their territories under NPPRs.

Non-EU AIFMs will therefore need to adopt a country-by-country approach in determining whether any (or all) of the new rules will apply in those EU Member States where they are marketing funds under available NPPRs.

WHAT ABOUT EU AIFMS MARKETING FUNDS IN THE UK?

The UK is no longer an EU Member State. Whilst the UK retained the AIFMD in its national law after the end of the transition period (as part of its on-shoring of existing EU financial services regulation), it is currently not anticipated that the UK will make the new EU rules part of UK domestic law.

This is one of the early occasions where we are going to see EU and UK financial services laws diverge.

EU AIFMs will continue to be treated as non-UK AIFMs/third country AIFMs for the purposes of the AIFMD as it now applies in the UK, including the existing UK NPPR.

LOOKING FURTHER AHEAD

Non-UK AIFMs will also want to keep a watchful eye over proposals expected from the EU Commission in the autumn of this year, coming out of the EU Commission's review of the AIFMD. These proposals could include a tightening of the AIFMD's NPPR provisions and limitations on the acceptable use of reverse solicitation.

The biggest surprise would be the extension of the AIFMD marketing passport to non-EU AIFMs. Alas, whilst the EU is always good for a surprise or two, an extension of the passport to non-EU AIFMs currently seems rather unlikely.

For non-EU AIFMs finessing their pan-European fund distribution strategies in light of the new rules, it remains very much a case of "watch this space and tread with care".

"THIS IS ONE OF THE EARLY OCCASIONS WHERE WE ARE GOING TO SEE EU AND UK FINANCIAL SERVICES LAWS DIVERGE.

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HAVE YOU GOT THE K-FACTOR?

FCA'S NEW PRUDENTIAL REQUIREMENTS HAVE SIGNIFICANT CONSEQUENCES FOR PRIVATE EQUITY

THE PROBLEM WITH THE CURRENT PRUDENTIAL REGIME IS ITS COMPLEXITY

The FCA is introducing new prudential requirements – covering capital, liquidity and remuneration – for all investment firms authorised in the UK under the MiFID. In broad terms, the new Investment Firm Prudential Regime **(IFPR)** will reflect the changes introduced in the European Union's Investment Firm Directive and Investment Firm Regulation, which the FCA supported, and was heavily involved in policy discussions to create, when the UK was a member of the EU.

The problem with the current prudential regime is its complexity, owing to it being based on requirements designed for banks that take deposits or engage in extensive lending activities.

The aim of the IFPR is to simplify and streamline those requirements, in a way that is sensitive to the actual risks incurred and posed by investment firms.

The IFPR will apply to UK MiFID investment firms and Collective Portfolio Management Investment firms **(CPMI firms)** (such as managers of alternative investment funds with additional permissions to provide "investment services"), capturing many private equity GPs as a result.

Despite lobbying from the private equity industry, the FCA is not minded to introduce a tailored regime for private equity. However, the FCA has issued helpful guidance on its interpretation of various rules which may be of particular interest to private equity houses.

PROPORTIONALITY

The prudential requirements of IFPR will scale with the size and complexity of the firm (known as "proportionality") and reduced obligations will apply to firms that qualify as "Small and Non-Interconnected" **(SNI)**. This will also impact other areas of the IFPR, such as disclosure and remuneration.

Whether a firm will qualify as an SNI will depend on a series of activity-based and quantitative thresholds using "K-factor" metrics. These are a new way of measuring the potential for harm caused to a firm, its clients and the market. The starting point is to assess whether K-factors apply in order to understand the likely impact of the new prudential regime and changes that will be necessary for compliance.

A potential pitfall arises for private equity "adviser-arrangers" in relation to the K-factor for assets under management **(K-AUM).** K-AUM measures the value of assets under discretionary management, but it also captures 'non-discretionary arrangements constituting investment advice of an ongoing nature'.

The FCA has clarified some points of interpretation that flow from this:

i. K-AUM applies to the MiFID activity of "investment advice" and other advisory services therefore do not need to be taken into account of K-AUM.

ii. K-AUM does not apply to corporate finance advice, which is provided for entrepreneurial purposes and in connection with an industrial strategy, rather than generating a financial return.

iii. Investment advice of an ongoing nature includes arrangements involving periodic or continuous investment advice and arrangements involving recurring advice. Genuinely 'one-off' or sporadic investment advice, that is not recurring, is not included.

Firms that provide MiFID investment advice to the same client repeatedly should consider their positions carefully and be able to justify why a particular set of advisory arrangements do not constitute 'investment advice of an ongoing nature'.

REMUNERATION

The IFPR introduces a new remuneration code that will have a significant impact on many private equity firms, particularly (but not limited to) those that are not currently subject to a remuneration code. There is added complexity for CPMI firms as they will continue to be subject to AIFM or UCITS Remuneration Codes, but must also apply the new remuneration code for their MiFID "top up" business.

Although the FCA notes that firms should continue to adopt a proportionate approach to compliance, it will no longer be permitted to rely on proportionality alone as a basis to disapply rules in their entirety. Instead, firms must comply with different levels of remuneration requirements according to which tier they fall within (basic, standard and extended requirements).

All firms (including SNIs) must comply with the "basic" requirements: to have a clearly documented gender neutral remuneration policy and certain governance and oversight requirements around the development and review of the policy. Additional "standard" requirements apply to non-SNI firms covering (amongst others) setting a ratio between fixed and variable remuneration, performance assessment and ex-post risk adjustment (including malus and clawback).

Finally, the "extended" regime will require the largest non-SNI firms to comply with rules on payment in instruments, deferral and vesting, retention and discretionary benefits.
Whilst the FCA has confirmed that it would consider carried interest as "remuneration", it will be valued at the time of its award, rather than pay out. Private equity houses will welcome the news that requirements on pay out in instruments, deferral, retention and ex-post risk adjustment will not apply to carried interest schemes that meet certain risk alignment conditions.

CAPITAL AND LIQUIDITY REQUIREMENTS

The initial capital requirement will increase for most firms and ongoing requirements will depend on whether it is an SNI firm or not which, once again, is a test determined by the K-factor metrics. The type of capital that must be held to satisfy a firm's capital resources requirement will change for firms that do not currently adhere to Capital Requirements Regulation **(CRR)** levels of capital quality (such as exempt CAD firms and BIPRU firms). The IFPR also creates a new basic liquidity requirement, which means that private equity firms (including SNI firms) must always have a minimum stock of liquid assets to fund the initial stages of a wind-down process. The requirement is calculated by reference to a firm's fixed overheads requirement and forms part of an overall framework that the firm should adopt for assessing its liquidity.

CONCLUSION

The regulatory environment for private equity houses is changing to better reflect the risks they face and pose to clients and the market. While there are some important details yet to be finalised, there is no doubt that major changes are afoot to investment firms' capital, liquidity and remuneration requirements. Indeed, for some firms the requirements will be completely new. The FCA's final rules are due to be published in Autumn 2021. With a target implementation date of January 2022, it is never too early to start preparations.

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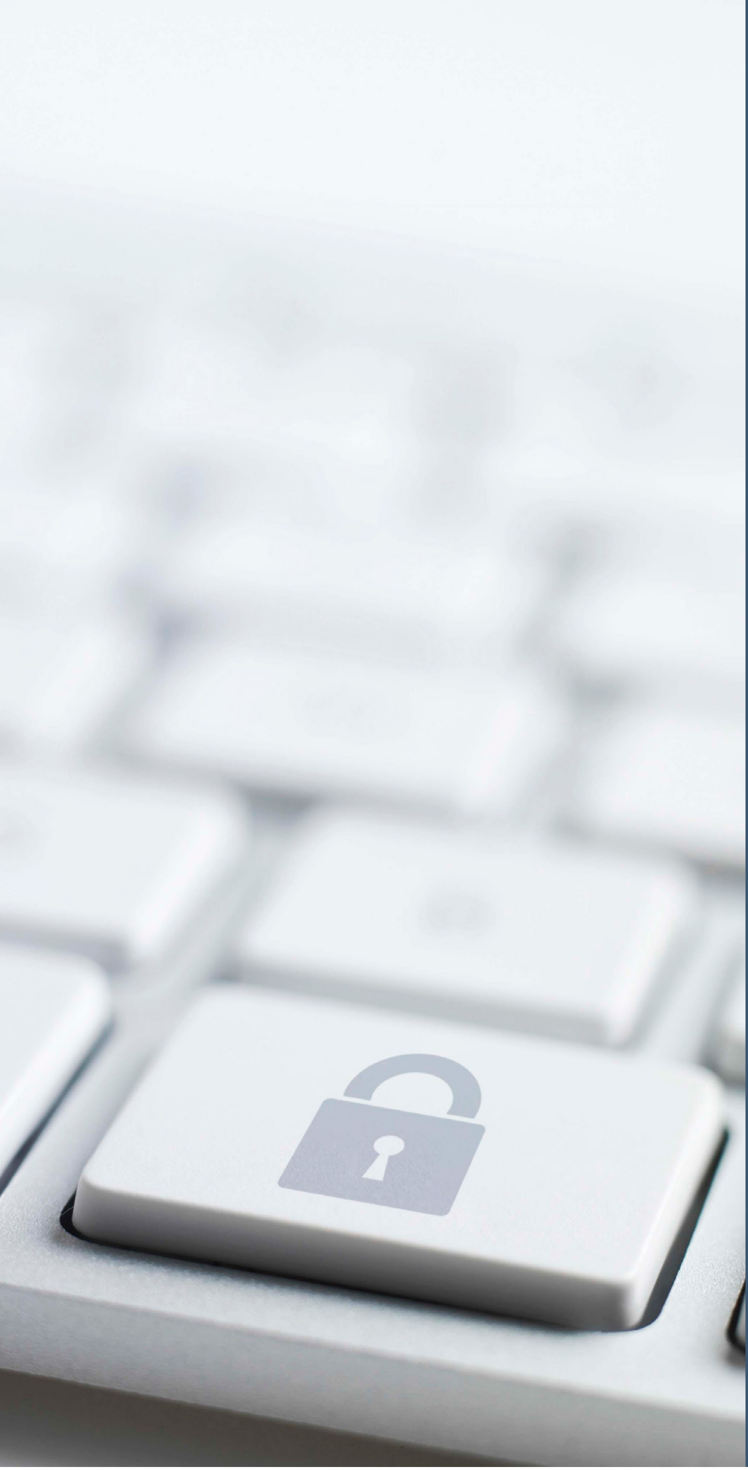
INTERNATIONAL DATA TRANSFERS



OUT WITH THE OLD, IN WITH THE NEW

THE NEW EU STANDARD CONTRACTUAL CLAUSES

WHAT PRIVATE EQUITY BUSINESSES NEED TO KNOW

The adoption of new EU Standard Contractual Clauses (**EU SCCs**) by the EU Commission on 4 June 2021 affects all international private equity businesses and portfolio companies sending personal data from the EEA. Data transfers to any territories not deemed 'adequate' from an 'EU data protection law' perspective, which may have been legitimised by the previous SCCs (**Old SCCs**), will now need to be replaced by the new EU SCCs.

While data transfers from the UK to territories not deemed adequate are subject to different rules following Brexit, the Information Commissioner's Office (**ICO**) has launched a consultation, closing on 7 October 2021, seeking responses on how organisations can continue to protect people's personal data when it's transferred outside of the UK– under the UK GDPR (the **ICO Consultation**).

Both the EU SCCs and the proposed international data transfer agreement (**IDTA**) referred to in the ICO Consultation require amending and updating existing contracts which include the Old SCCs.

CALENDAR FOR IMPLEMENTATION OF THE EU SCCS

- **27 June 2021:** The new EU SCCs entered into force.
- **27 September 2021:** The Old SCCs ceased to be valid for future use. During this period, controllers and processors can enter into either the Old SCCs or the new EU SCCs.
- **27 December 2022:** Deadline for implementation of the new EU SCCs. Parties will not be able to rely on the Old SCCs anymore.

WHAT IS THE SCOPE OF THE EU SCCS?

The new EU SCCs repeal and replace the existing Old SCCs (dated 2001, 2004 and 2010) i.e. the previous controller-to-processor and controller-to-controller EU SCCs. They reflect the new requirements under the EU GDPR and also take into account the Judgment of the CJEU in Schrems II of 16 July 2020 (**Schrems II**).

WHO CAN USE THESE NEW EU SCCS?

They can be used by any company as a data exporter which is subject to the GDPR. The data exporter may be based in the EEA but, for the first time, the data exporter may also be established outside of the EEA.

This would be the case if a controller is subject to the GDPR on an extra-territorial basis. For instance, under Art. 3 (2)(a) of the GDPR, a controller based outside of the EEA could use Module 4 for processor-to-controller clauses if this controller would be offering goods and services to data subjects in the EEA, and would want to transfer EU customer personal data to a processor based in the EEA.

The new EU SCCs cannot be used, however, if the data importer is already subject to the GDPR. The new EU SCCs won't need to be used if a data exporter based in the EEA transfers data to a data importer based outside of the EEA, who is subject to the GDPR on an extra-territorial basis.

HOW TO USE THE NEW EU SCCS

The new EU SCCs adopt a modular approach in the sense that they contain modular content, which only applies to some of the 4 specific scenarios as follows:

- From a controller to another controller (C2C);
- From a controller to a processor (C2P);
- From a processor to a processor (P2P); and
- From a processor to its appointing controller (P2C).

STRUCTURE AND APPROACH OF THE NEW EU SCCS

Many of the clauses will look familiar from the Old SCCs. The content of the new EU SCCs will depend on the modules being selected, but they mainly address the following requirements that are:

- Safeguards and obligations.
- Dealing with data subject requests (including the obligation to provide a copy of the clauses to the data subject, if requested).
- Use of sub-processors and onward transfers.
- Redress and liability.
- Dealing with requests for access to data made to the importer by authorities.
- Article 28 GDPR requirements for processing arrangements.

THE NEW EU SCCS INCLUDE WELCOMED NEW FEATURES:

- They can be used by multiple parties instead of the usual two parties for the Old SCCs.
- They include a docking clause which allows additional new controllers and processors to accede to the new EU SCCs as data exporters or data importers.
- The law of the exporting country will not automatically apply. There is more flexibility to choose a country in the EU, provided the laws of the country give third party rights for beneficiaries. This was an issue for Ireland but is no longer the case, with a new law in place to fix the problem.
- The EU SCCs' terms prevail over any other terms entered into by the parties.
- Liability extended under the new EU SCCs: there is joint and several liability to data subjects (Art 82) and extended rights of claim for data subjects.

ADDRESSING SCHREMS II REQUIREMENTS

The new EU SCCs include all the principles set out in Schrems II. They also retain the principles in the Old SCCs, which are:

- The obligation for the data exporter (with the assistance of the data importer) to consider the level of protection of personal data in the third country;

- The obligation of the data importer to notify the data exporter if it is unable to comply with the SCCs; and
- A resulting obligation for the data exporter to suspend any such data transfers or terminate the agreement.

Private Equity businesses are required to carry out and document Transfer Impact Assessments (**TIAs**) on a case-by-case basis to assess transfers in respect of the local laws and practices of the destination country, and make it available to the competent supervisory authority on request.

The European Data Protection Board (**EDPB**) published helpful and comprehensive final guidance on 21 June 2021, including recommendations on measures supplementing transfer tools (such as SCCs) to ensure compliance with the EU required level of protection (**EDPB Final Guidance**). The new SCCs should be used whilst taking account of the EDPB Final Guidance.

The EDPB Final Guidance has moved more towards the EU SCCs' approach by acknowledging a more risk-based approach to the risks presented by the laws of a third country. It now recognises both objective and subjective considerations. Both what the laws say and also what actually happens in practice in a country matter.

Thanks to the new EU SCCs, we finally seem to be heading towards more clarity of the rules governing international data transfers under the laws of the European Union.

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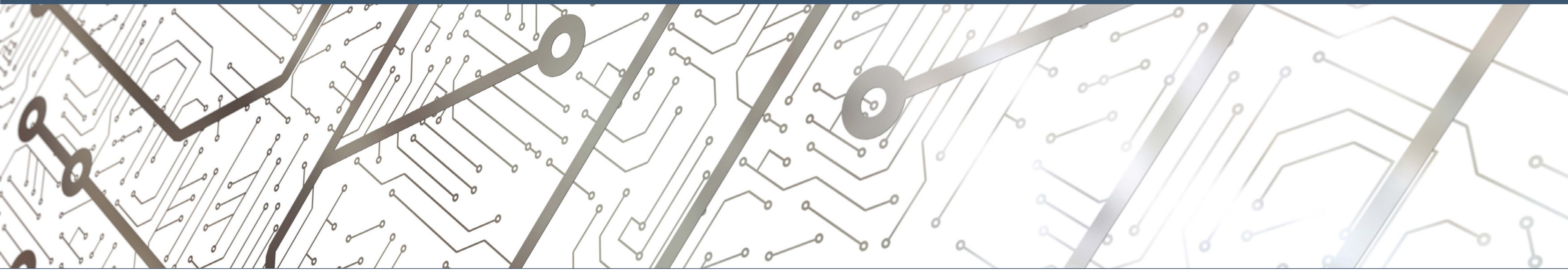
> **PRIVATE EQUITY BUSINESSES ARE REQUIRED TO CARRY OUT AND DOCUMENT TRANSFER IMPACT ASSESSMENTS (TIAS) ON A CASE-BY-CASE BASIS.**



4

FUND FINANCE TRENDS

GETTING PUNCHED IN THE FACE...

FUND FINANCING SOLUTIONS TO INVESTMENT PORTFOLIO ISSUES

In this article, we're going to take a look at Fund level (as opposed to individual investment level) fund financing solutions to address the times when the business plan doesn't quite turn out as expected – whether it's for individual investments within a portfolio or for the portfolio as a whole.

The Fund's ability to manage performance issues, whether those are issues of over-performance or underperformance (or both at the same time!) is set within the context that returns are maximised for the Fund's Investors, and that sufficient income and "carry" is generated to ensure that the Fund's executives and employees remain incentivised (and, more importantly, paid!)

SO WHAT ARE WE SOLVING?

We are going to specifically look at the following issues with investment portfolios:

- General issues with an investment portfolio "across the board"- this is often a result of an external and unanticipated event which affects the whole of the market of that portfolio (or all markets generally) – the most obvious recent example being the onset and continuing impact of Covid-19;
- Specific issues with one or two investments within a wider portfolio – so, if underperforming, this would include the "bad apples" problem; and
- Delays in the realisation or disposal of particular assets in a portfolio.

> **EVERYBODY HAS A PLAN UNTIL THEY GET PUNCHED IN THE FACE.**
>
> Mike Tyson

"

HISTORICALLY, FINANCING AT THIS LEVEL WAS PRIMARILY FOCUSED ON MANAGING "DOWNSIDE" RISK. NOW THE SPOTLIGHT IS SHIFTING TOWARDS ACTIVE MANAGEMENT OF PORTFOLIOS AND INVESTMENT WITHIN THEM.

SOLUTIONS

Given that the issues are with Fund investments, we are looking at solutions led by the Funds and their GPs as opposed to solutions at the Investor level.

CONTINUATION FUND

Where there is a general need or desire to look for more time to maximise the value of, or to work out existing issues with, a whole portfolio, the GP can establish a continuation vehicle to take over the residual portfolio. Existing Investors will be given the option to either cash out or to roll their investment into the new continuation Fund, and new Investors will be given the opportunity to invest in the continuation Fund. Financing can be sought in the continuation Fund (either subscription financing, asset level financing, or both) which can be used to ease the transition in a number of ways, whether individually or combined. Examples would include: (i) funding the cashing out of existing Investors in the previous fund; (ii) funding particular cash refunds so as to incentivise the existing Investors to transfer part (at least) of their interest to the continuation Fund; (iii) funding required by the continuation Fund for the investments (including for follow-on investments or enhancements of existing investments).

Similar solutions can be used for issues with part of a portfolio e.g. where the GP needs more time to manage or maximise returns on single or select assets.

What issues are going to come up in financing?

- Set up costs are higher in setting up a new continuation vehicle.
- Due diligence of the new investors can be time consuming, costly and require "lender sign off".
- Asset level financing is slightly more expensive than subscription financing (the "cheaper option"), although costs can be mitigated to some extent if the asset financing is combined with a subscription financing.

PORTFOLIO STRIP SALE

This is a mechanism whereby a specific portion of an existing Fund's assets can be sold to a new buyer (often established and managed by the GP) but with new Investors in the new buyer. Monies can be raised by fund financing of the new fund (by subscription financing or asset level financing or both) to finance the acquisition and pay off the Existing Investors in the Existing Fund.

What issues are going to come up in financing?

- Set up costs for the new buyer.
- Due diligence of the new investors can be time consuming, costly and require "lender sign off".
- Subscription financing is considered the "cheaper option" out of the various financing options but again costs can be mitigated to some extent if the asset financing is combined with subscription financing.

PREFERRED EQUITY

A new vehicle is established to provide equity financing for an existing investment portfolio within an existing Fund, which can be utilised to provide extra follow on capital for investments and/or to provide returns to existing Investors. This solution does almost always require renegotiation of existing terms with existing Investors, because the return on the preferred equity piece needs to have some sort of priority in the normal "waterfall" of Investors' return of distributions. It is however a solution worth considering, particularly where a Fund has already reached any leverage limits imposed by its constitutional documents because (provided it is structured in the right way) an equity injection does not constitute "borrowing" so does not contribute towards any breach of a "leverage" limitation in the Fund documentation. The vehicle through which the preferred equity is injected can itself be financed so, in effect, leverage is provided through the preferred equity route.

What issues are going to come up in financing?

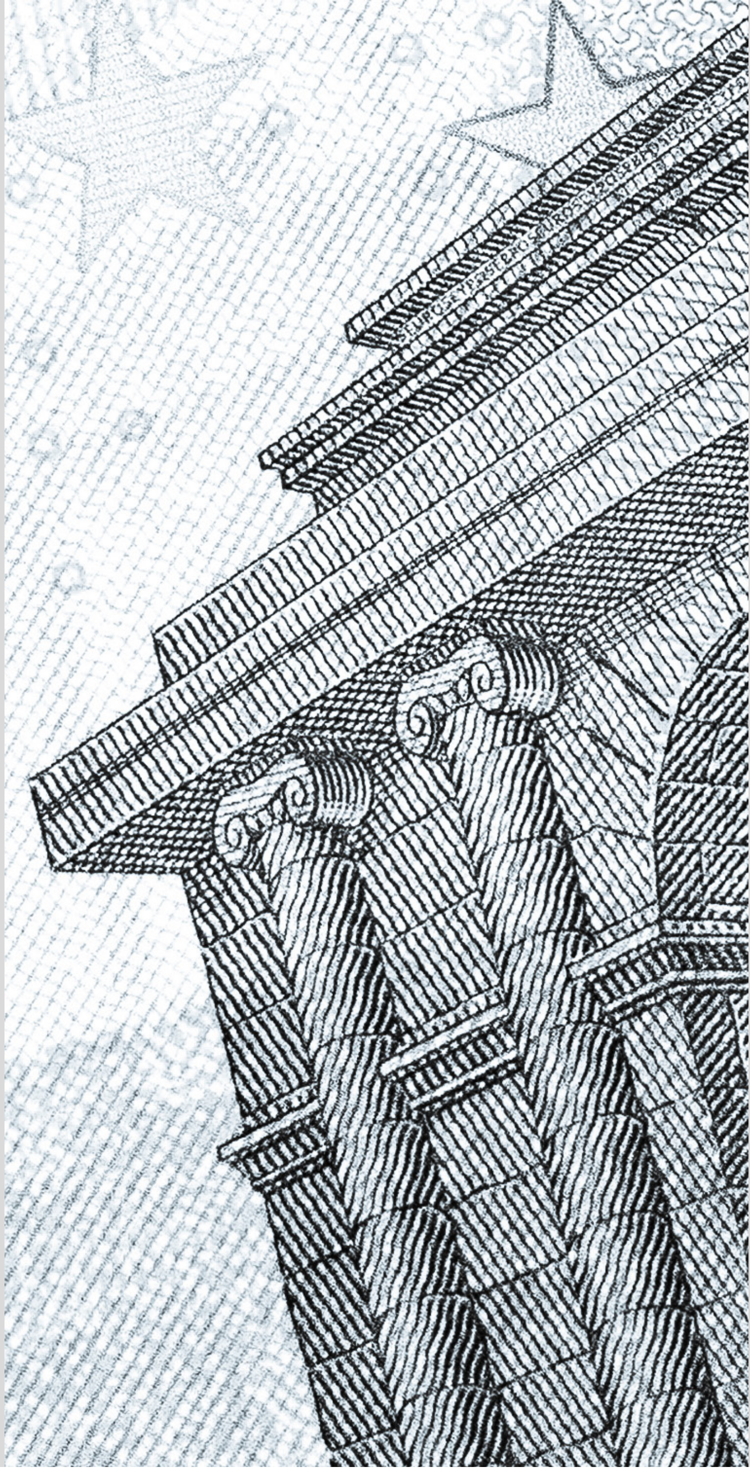
- One of the more "costly" forms of financing as compared to the traditional subscription financing as this solution requires renegotiation of existing terms e.g. waterfall and equity can be more expensive than debt.
- Due diligence of the new investors can be time consuming, costly and require "lender sign off".
- Security will be focussed more on the preferred equity vehicle itself and the cash flows flowing into that vehicle (and less upon the nature of the financing on the underlying assets, even at share level).

ESTABLISHMENT OF A FURTHER SUB-FUND OR PARALLEL FUND

In some ways, this is similar to setting up a continuation Fund, with existing Investors and the new Investors having the option to participate in the sub-fund or parallel Fund. The difference is that this is more likely to be suited to a situation in which the primary requirement for further investment or financing is to continue or enhance existing Investments rather than add new Investments. Financing can be obtained for the new vehicle, most likely in the form of a subscription financing of the Investor commitments and/or a financing of the underlying assets.

What issues are going to come up in financing?

- Similar issues as setting up a continuation Fund.



STAPLED TRANSACTIONS

This is where the GP organises the sale of secondary interests in a Fund to a buyer and simultaneously the buyer agrees to make a primary commitment to a new (or other existing) Fund managed by the GP. Either the purchase by the buyer and/or the commitment to the new Fund can be financed, noting that such financing would be at Investor level.

What issues are going to come up in financing?

- Similar issues to those in setting up a Continuation Fund but noting that the financing arrangements may include both the funding of the purchase and/or the funding of the buyer's commitment.

WHAT WILL THE FINANCIERS BE LOOKING AT FOR ALL OF THE ABOVE SOLUTIONS?

Potential financiers will be looking in particular at the following:

1. Is the financing at the right "level"?
2. Are there identifiable assets and cash flows (whether investor commitments or investment assets), out of which the loans and any other related payments (e.g. interest) can be funded and repaid?
3. Are the cash flows (in normal circumstances) sufficient to pay the debt and related costs and interest due under the Finance documents?
4. Are the assets and cash flows held as security sufficient to cover the whole of any actual (or potential debt), preferably with some headroom?
5. Is the security permitted and not restricted by any terms of any particular assets?
6. Can the security be realised by the Financier easily and quickly if required?
7. Does the Fund and the constitutional documents allow for borrowing and for the security and the cash flows to be taken out and/or paid up as required?

The above is a non-exhaustive list of the issues and solutions available in the funds financing market relating to investment portfolios - if you would like to know more, please do get in touch.

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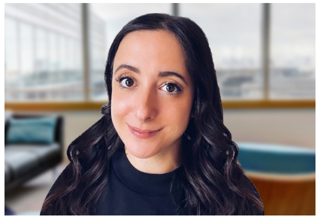
PROBLEMS. POSSIBILITIES.
COMPLEXITY. CLARITY.
OBSTACLES. OPPORTUNITIES.
THE DIFFERENCE IS IMAGINATION.

AUTHORS



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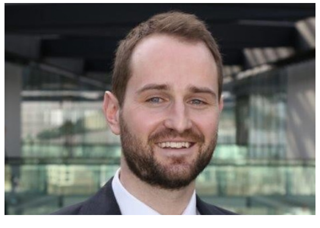

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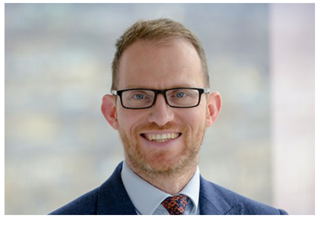

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