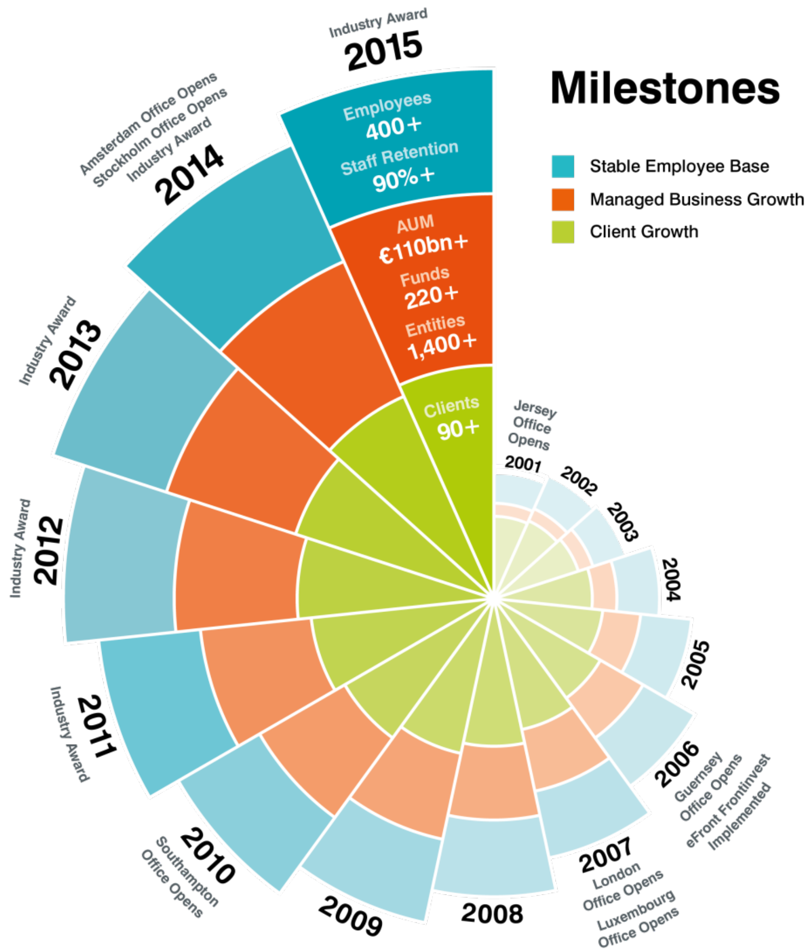
Trends and Developments in European Private Equity

James McCarthy

19 May 2016

AZTEC GROUP

Aztec Group: In Overview



- Established in Jersey in 2001
- Independent and owner-managed
- Now in excess of 500 employees
- 6 offices: Jersey, Guernsey, Luxembourg, the UK, the Netherlands and Sweden
- Fund Administrator of the Year: 2016 Private Equity Awards

AZTEC GROUP

Aztec Group: In Overview

Product

2001–2015

- Fund Services
- Corporate Services
- Advanced Portfolio Services
- Depositary Services

Asset Classes

- Private Equity
- Real Assets
- Debt Instruments

Operational Bases

2001–2015

- Jersey 2001
- Guernsey 2006
- Luxembourg 2007
- United Kingdom 2010
- Sweden 2014
- Netherlands 2014

AZTEC GROUP

1. A challenging time for the PE industry….

- Increase in fund regulation following financial crisis

- **Alternative Investment Fund Managers Directive (Directive 2011/61/EU) (July 2011)**
  - Equates PE funds with hedge funds / imports concepts from UCITS
  - Not the harmonising legislation it was intended to be: differing approaches to implementation = jurisdictional arbitrage

- **EuVECA Regulation (Regulation 345/2013) (July 2011)**
  - An "opt-in" option for sub-threshold AIFMs
  - Based on AIFMD: a marketing passport but with reduced compliance
  - Not proving as popular as expected

A challenging time for the PE industry….

- **Investor Regulation (new capital requirements):**
  - Solvency II / IORP II / Banking Structural Reform
- **BEPS**
  - "Base erosion" (reducing taxable profits in high tax jurisdictions)
  - "Profit shifting" (moving profits from one jurisdiction to another)
  - Targets international groups employing "creative" tax structuring to reduce tax
  - PE funds structured to promote tax transparency / avoid double-taxation for investors: **not to reduce tax**
  - **BUT**… PE funds likely to be caught:
    - Hybrid instruments
    - Limits on interest deductibility
    - Tax treaty abuse
    - Permanent establishment rules

A challenging time for the PE industry….

- **PE often misunderstood by public / politicians / press**

- **Equated with:**
  - Hedge funds (turning a “quick buck” for no “value-add”)
  - Investment banks (reckless investment in esoteric products)
  - International corporate groups (structuring to reduce tax to bare minimum)

- **PE industry campaigning hard to be understood:**
  - Employer of “real people” / job creator
  - Advisor / manager co-investment: interests aligned with investors
  - Illiquid, long term investments
  - Generating returns by adding value
  - ….yet still an uphill struggle

2. A challenging time for the CI….

- **Public sentiment set against offshore jurisdictions / structures**
  - The Panama Papers:
    - Well regulated / transparent offshore jurisdictions (CI) vs loosely regulated / opaque “tax havens” (Panama)
    - Misunderstanding of rationale for offshore PE structuring

- **Political sentiment also against offshore jurisdictions / structures**
  - Investor regulation penalises offshore investment via higher capital costs
    - Solvency II
    - IORP
    - Banking Structural Reform

AZTEC GROUP

A challenging time for the CI….

- **No third country passport for the CI…yet**
  - ESMA's recommendation issued on 30 July 2015
  - "*No obstacles exist to the extension of the third country passport*" to the CI
  - Strong endorsement of integrity of CI funds industry
  - **BUT…** passport delayed until a "*sufficient number*" of other third countries are approved in principle to avoid market distortion
  - ESMA to assess other third countries by 30 June 2016, but how long will CI have to wait?

A challenging time for the CI….

Investor regulation

- **Solvency II (January 2016)**
  - Applies to EU insurance companies
  - "Standard" risk capital weighting measurement model:
    - **39% risk capital weighting** for "Type 1" equities
    - Includes equities held by PE funds which are:
      - EuVECA designated; or
      - Closed-ended; and
      - Unleveraged; and
      - **Established in the EU or marketed in the EU using the AIFMD third country passport.**
  - Equities held by offshore funds are therefore "Type 2" equities:
    - **49% risk capital weighting**
  - Larger insurers use "internal" risk measurement models
    - Must be approved by regulators
    - How will PE be treated / influence of standard model?

AZTEC GROUP

A challenging time for the CI….

- **Banking Structural Reform**
  - Will apply to banks which are “too big to fail”
  - Ban on proprietary trading
  - Exception for PE funds which are:
    - EuVECA designated; or
    - Closed-ended; and
    - Unlevered; and
    - **Established in the EU or marketed in the EU using the AIFMD third country passport.**

AZTEC GROUP

A challenging time for the CI….

- **IORP II**
  - Applies to EU pension funds
  - Solvency II-style risk capital weighting discussed but abandoned – Member States to legislate
  - Risk of protectionist policy-making:
    - German Investment Regulation and Pension Fund Capital Regulation (amended February 2015)
    - Drafts effectively banned German insurers and pension funds from investing in funds managed by most non-EEA managers
    - Final legislation an improvement: existing fund investments grandfathered / Solvency II supersedes for insurance companies from Jan 2016, **BUT…**

AZTEC GROUP

A challenging time for the CI….

- **Pension funds restricted to PE funds which:**
  - **are established in an EEA / full OECD member state**
    - Jersey / Guernsey are full members of OECD via UK membership
    - HMRC and Ministry of Justice moved to clarify position vis-à-vis Guernsey in August 2015

  and

  - **have managers which:**
    - are domiciled in an EEA / full OECD member state; and
    - are subject to public supervision for the protection of investors; and
    - **hold a licence / registration "comparable" to that under the German Capital Investment Act**
      - AIFMD authorisation deemed "*comparable*"
      - Unclear what else will be deemed "*comparable*"

AZTEC GROUP

What’s the net effect?

- **Absent an AIFMD passport, marketing options for offshore funds raising EU capital are:**
  - National private placement regimes (potential issues of timing / cost)
  - Reverse solicitation (some debate over what is and isn’t RS)

- Managers of / investors in existing CI structures generally happy to stay in CI **BUT**…

- Some EU managers moving on-shore due to social / political / investor pressures

- New managers generally staying on-shore

- Overseas (e.g. US) managers frequently raising capital outside EU

AZTEC GROUP

3. Increased competition: New fund structures

- **UK "Private Fund Limited Partnerships" (awaited)**
  - Applies to CIS which are **not** FCA authorised and which are constituted by written agreement
  - Existing LPs can be re-designated within 12 months of reform order coming into force
  - Key proposed changes:
    - "White list" of permitted LP management activities – no loss of limited liability
    - No requirement for LPs to contribute capital
    - Restrictions on withdrawal of capital lifted
    - "Out-of-court" winding up procedure
    - Easier to remove from register / strike off if fund is inactive
    - Reduced Companies House registration particulars (no details of capital contributions, term, general nature of business)
    - No need to advertise assignments of LP interests in Gazette

Increased competition: New fund structures

- **The Luxembourg Reserved Alternative Investment Fund ("RAIF")**
  - Expected Q2 2016
  - A game-changer for Luxembourg:
    - Similar to a Specialised Investment Fund (SIF) **BUT…unregulated and AIFMD passportable**

- **Key features:**
  - Reduced time to market
    - No regulatory approval for fund: CSSF notification only
    - AIFMD-compliant / passportable
      - Must appoint an external **AIFMD-compliant** AIFM
      - Until third country passports available, **AIFM must be established in EU**

  - Limited ongoing CSSF notification / reporting requirements

Increased competition: New fund structures

- **Key features (continued):**
  - Sub-funds / compartments and cross investments possible (a first for unregulated structures)
  - Suitable for a range of PE investors:
    - Professional
    - Institutional
    - Carried interest
    - Sophisticated (i.e. certified by regulated intermediary / self-certifying, subject to EUR 125k minimum investment)
  - Limited investment restrictions (subject only to disclosure in PPM)
  - SIF-style risk-spreading requirements (cap of 30% of committed capital / NAV per asset)

Increased competition: New fund structures

- **Key features (continued):**
  - Structuring flexibility:
    - Fixed capital (SICAF) (closed ended) or variable capital (SICAV) (open ended)
    - SA (public company / tax opaque)
    - Sarl (private company / tax opaque)
    - SCA (incorporated partnership limited by shares / tax opaque)
    - SCS (limited partnership / tax transparent)
    - SCSp (special limited partnership / tax transparent)
    - FCP (similar to UK unit trust / tax transparent)
  - Tax treatment optionality:
    - SIF vs SICAR (Investment Vehicle in Risk Capital)

Increased competition: New fund structures

	SIF	SICAR
Annual Subscription Tax	Yes (0.01% of NAV)	None
Net Wealth Tax	None	EUR 3,210 (if 90% + of assets held are securities and cash)
WHT on dividends	None (subject to EU Savings Directive)	None
WHT on interest	None (subject to EU Savings Directive)	None (subject to EU Savings Directive)
WHT on redemptions / capital reductions	None	None
WHT on liquidation	None	None
Corporate Income Tax	None	None on: • Income derived from transferable securities • Cash held <12 months pending investment in risk cap assets • Income derived from investments held <12 months
Municipal Business Tax	None	Calculated on amounts which are not otherwise exempted (i.e. very little)

AZTEC GROUP

4. VAT - *Eenheid* decision

- *Fiscale Eenheid X NV* (C-595/13)

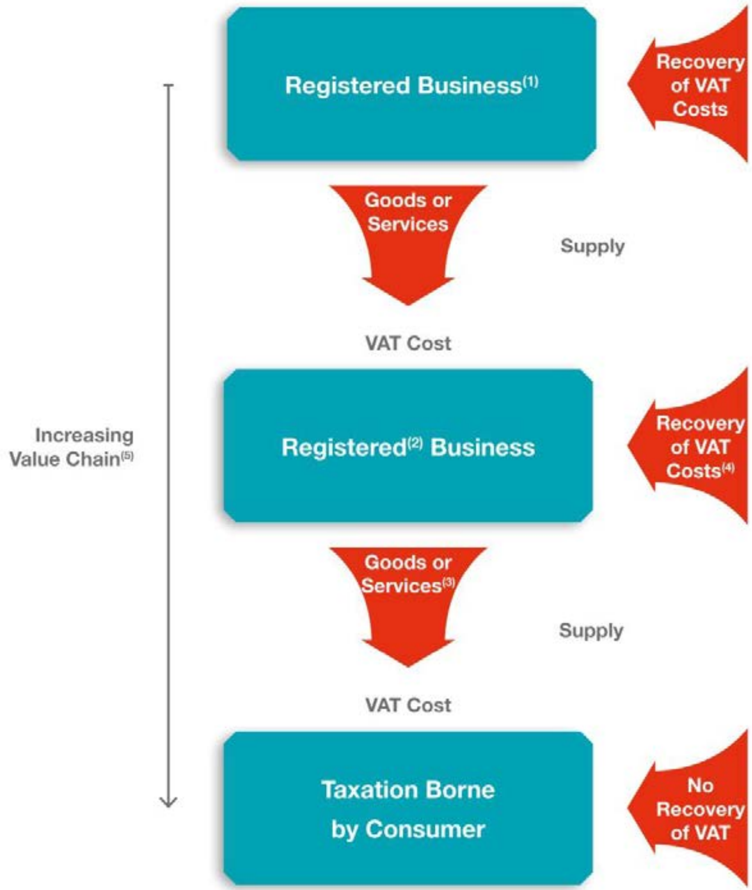
- ECJ issued decision on 9 December 2015

- Does the fund management VAT exemption apply to portfolio and property management services provided to:
  – a non-UCITS fund vehicle,
  – investing solely in real estate assets?

- First time ECJ has expressly considered a non-UCITS fund investing in solely in assets other than transferable securities

AZTEC GROUP

VAT - *Eenheid* decision



Notes:

1. An EU tax which “bites” at every level of a supply chain when goods and services are supplied in the course of business.

2. Must register for VAT if certain thresholds exceeded.

3. Different rates / rules apply across the EU. Goods / services can be:
   - Outside the scope of VAT (with recovery)
   - Exempt from VAT
   - Zero-rated
   - Positive rated (full or reduced rate)

4. To reclaim VAT paid (“input VAT”) a business:
   - must be VAT registered; and
   - must in turn make VAT’able supplies in the course of business.

5. End consumers (i.e. those acquiring goods / consuming services other than in the course of business) cannot reclaim VAT.

6. Exempt supplies = no recovery or reduced recovery, depending on the blend of VAT’able and exempt supplies made.

7. Pro rata approach adopted to determine input recovery where multiple types of service supplied.

VAT - *Eenheid* decision

- **History of fund management VAT exemption:**
  - VAT Directive (2006/112/EC): exemption for fund management services provided to "*special investment funds*"
  - Member States given discretion to define "*special investment funds*" (Article 135(1)(g))
  - Jurisdictional arbitrage
    - E.g. UK defined narrowly / Lux defined broadly
  - Subsequent ECJ rulings seek to harmonise approach across EU

VAT - *Eenheid* decision

- Pre-Eenheid cross-border structuring options / VAT treatment: UK manager / Lux fund

Tax Domicile of Manager	Tax Domicile of Fund	VAT Point (place of supply)	VAT Treatment in Manager's Domicile	VAT Treatment in Fund's Domicile	Neutral for Manager?	Neutral for Fund?
UK	Lux	Lux	Overseas, closed-ended, unlisted PE funds **do not qualify** as "special investment funds" in the UK Therefore VAT exemption **does not apply** and the supply is VAT'able	Exempt	Yes (if manager is VAT registered)	Yes (supply is exempt)

AZTEC GROUP

VAT - *Eenheid* decision

- Pre-Eenheid structuring options / VAT treatment: UK manager / CI fund

Tax Domicile of Manager	Tax Domicile of Fund	VAT Point (place of supply)	VAT Treatment in Manager's Domicile	VAT Treatment in Fund's Domicile	Neutral for Manager?	Neutral for Fund?
UK	CI	CI	Outside scope of VAT with recovery (zero VAT)	No VAT (outside EU)	Yes (if manager is VAT registered)	Yes

AZTEC GROUP

VAT - *Eenheid* decision

- **The ECJ's decision**
  - Property management services are **not sufficiently specific** to fund management to qualify for VAT exemption **BUT….**
  - Fund management services **should qualify** for VAT exemption because real estate funds **are** "*special investment funds*"
- **Rationale:**
  - Traditional analysis: "*special investment funds*" = funds that are "*sufficiently comparable to UCITS*" to be considered to be "*in competition*" with UCITS
  - Class of assets invested in used to be key factor (i.e. transferable securities)
  - **Key (new) requirement:** fund must be subject to "*specific state supervision*" – the class of assets invested in is irrelevant
- ***"Specific state supervision*" not defined**

AZTEC GROUP

VAT - *Eenheid* decision

- **Uncertainty**
  - What qualifies as "*specific state supervision*"?
    - In-scope AIFMD AIFs?
    - EuVECA?
    - Sub-threshold non-EuVECA AIFs?
  - How will *Eenheid* be implemented by Member States?
    - Narrow interpretation (real estate asset funds only) vs broad (any fund subject to regulation, even if "light-touch")
    - UK has construed previous ECJ decisions narrowly
      - *JP Morgan Fleming Claverhouse:* VAT exemption expanded to include investment trusts
      - *ATP Pension Services*: VAT exemption expanded to include certain defined contribution pension schemes
  - Impact on existing fund structures?
    - Renegotiation of contracts if managers unable to pass on irrecoverable or wrongly deducted VAT?
  - Impact on new fund structures?
    - Onshore with lower regulatory capital costs / AIFMD passport, but VAT inefficiency?
    - Offshore with VAT efficiency, but higher regulatory capital costs / higher marketing costs?

VAT - *Eenheid* decision

- **Implications:**
  - CI continues to offer certainty of VAT treatment and VAT efficiency

Tax Domicile of Manager	Tax Domicile of Fund	VAT Point (place of supply)	VAT Treatment in Manager's Domicile	VAT Treatment in Fund's Domicile	Neutral for Manager?	Neutral for Fund?
UK	Lux	Lux	Exempt	Exempt	No – an exempt supply	Yes
UK	CI	CI	Outside scope of VAT with recovery (zero VAT)	No VAT (outside EU)	Yes	Yes

AZTEC GROUP

Conclusions

- **A challenging time for the CI and PE in general**
  - Risk of a gradual shift on-shore

- **Jersey remains a strong candidate for international funds business**
  - Structuring optionality
  - Well-understood
  - Well-regulated
  - High quality services industry
  - Political stability
  - Tax efficient / VAT certain

- **Hybrid fund structures: The Bright Solution?**
  - Onshore fund + onshore AIFMD-compliant manager + offshore operation of GP and fund platform = **AIFMD passportable product + reduced reg. cap. costs for investors + offshore VAT treatment**
  - AIFMD-compliant fund operated alongside fund structures accommodating non-EU investors (e.g. AIFMD pool, ERISA pool, Non-ERISA pool)

- **BUT….**
  - BREXIT may change the landscape again….
  - ESMA to opine on other third countries re: AIFMD passports on 30 June 2016

AZTEC GROUP