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- Weil Gotshal advised Lehman Brothers Holdings Inc. in connection with the management buyout of Neuberger Berman, its investment management business, and certain of its alternative asset businesses
- Weil Gotshal advised Credit Suisse and General Electric in connection with their joint venture with Mubadala Development Co. to form a Middle East North Africa infrastructure fund
- Weil Gotshal advised Lee Equity Partners, LLC in connection with the formation and $500 million capitalization of MidCap Financial Holdings, a specialty finance company focused on healthcare lending
- Weil Gotshal advised Natixis Investissement Partners in connection with its sale of Aerocan France SAS to Barclays Private Equity France
- Weil Gotshal advised Advent International Corp. in connection with its acquisition of specialist healthcare provider Craegmoor Healthcare Group from Legal & General Group
- Weil Gotshal advised Lion Capital in connection with its acquisition of Advang Holding B.V., the leading branded producer of frozen snacks and appetizers in Benelux
- Weil Gotshal advised Bancroft Eastern Europe Fund in connection with its sale of Bonton Music, a.s.
- Weil Gotshal advised Bancroft Eastern Europe Fund in connection with its acquisition of Frost s.r.o.

European Regulatory Initiatives Affecting Private Equity Sponsors and Hedge Funds

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The current global financial markets crisis is spawning a predictable result with a push by politicians and regulators to propose greater regulation, including regulation that affects private equity sponsors and hedge funds. In Europe, there have already been proposed a number of such changes. This article summarizes some of those proposals by the European Union as well as by France, Germany and the UK. This article also summarizes certain tax changes in France affecting the private equity industry.

EU

Following publication of reports drawn up by two Members of the European Parliament (Mr Klaus-Heiner Lehne and Mr Paul Rasmussen) in July and September of this year recommending stricter legislative control on the private equity industry, the European Parliament called on the European Commission to submit legislative proposals regarding private equity and hedge funds pursuant to two resolutions dated September 23, 2008. The requested proposals included legislation based on the following principles:

- mandatory compliance with capital requirements for all types of investment firms reflecting risk from the type of business, exposure and risk control;
- clear disclosure and communication of material information to investors and target companies;
- limitation of leverage at a level sustainable for the private equity fund/firm and the target company;
- prohibition of unreasonable "asset stripping" and related capital depletion; and
- alignment of reward packages with long term outcomes, reflecting losses as well as profits.

It is not clear what legislative proposals, if any, will arise as a result of these resolutions or the timing of any legislative proposals.

In addition, following the more recent G20 declaration on regulatory reform of the financial sector, on December 11, 2008 the European Commissioner for Internal Market and Services, Charlie McCreevy, announced a review of the voluntary codes of practice in the private equity industry to assess their impact and effectiveness. He proposes to focus on the following issues:

- *Coverage of voluntary codes*. Only 32 of a possible 200 members of the British Venture Capital Association (the "**BVCA**") have signed up to the Walker guidelines on disclosure and transparency (although the BVCA argues that those 32 signatories account for more than 80 per cent by value of private equity funds under management in the UK). Such a low percentage provides grist to the mill for those arguing for legislation to replace voluntary codes and undermines Mr McCreevy's belief that "self-regulation represents the most promising avenue for promoting the desired behavior by private equity managers".
- *Monitoring and mechanisms for improving compliance*. Voluntary codes rarely have mechanisms for measuring compliance with their recommended standards. The review will consider the scope for giving voluntary codes teeth by moving to a more active and independent "comply or explain" style of compliance.
- *Consistency across Member States*. The industry codes currently in place in different jurisdictions in Europe differ significantly in content. There may be a drive to consolidate these codes into a pan-European code taking the best practices from each jurisdiction.

The Commissioner will present to the European Parliament in March 2009 his initial findings on these issues together with the impact of buy-out activity on the social economy, the management of relationships with key stakeholders, corporate governance and the alleged over-leveraged nature of some private equity deals.

FRANCE

As in other European countries, the private equity industry attracts in France more attention than ever. So far, public scrutiny has focused on the remuneration of managers in LBO transactions and, to a lesser extent, on the tax treatment of carried interest. Despite the current quite "friendly" environment for the private equity industry in France, there is a concern that the deterioration of the economy in general and the expected rise in the default rate for leveraged loans will lead to greater regulation of the industry.

The recent rules and proposals described below are a good illustration of the willingness of the French authorities to develop further the private equity industry in France on the one hand and the political need to tackle certain issues that attract public attention on the other hand.

These recent rules and proposals are a result of different regulations and concern various matters mainly relating to the structure of private equity funds, taxation and, upon the initiative of the French financial markets authority *Autorité des marchés financiers* ("**AMF**"), stock exchange matters.

Structure of private equity funds

The law of "modernization of the economy" dated August 4, 2008 introduced some important changes to the rules governing the "FCPR" (*fonds commun de placement à risques*), the main private equity vehicle in France, and a new category of investment vehicle, the "contractual FCPR". These measures aim at making French private equity vehicles more attractive compared to foreign limited partnerships.

The law removed certain restrictions applicable to the "FCPR allégés" (i.e., FCPR reserved to "qualified" investors), which may now:

- invest in entities organized in non-OECD member countries, such as the limited partnerships of the Cayman Islands, Jersey or Guernsey; and
- grant shareholder's loan to any company in which they hold an interest, irrespective of the size of the investment (previously, the relevant fund had to hold at least 5% of the company's equity).

The creation of an unregulated FCPR, the so-called "contractual FCPR", is another innovation of the law of modernization of the economy.

Very few conditions apply to this new vehicle which is reserved to "qualified investors":

- contractual FCPRs do not have any quota requirements — whereas at least 50% of the FCPR allégés' assets must be invested in certain eligible securities;
- contractual FCPRs may borrow as much as permitted by their by-laws whereas indebtedness of an FCPR allégé shall not exceed 10% of its assets; and
- shares issued by contractual FCPRs may be subject to a lock up period exceeding ten years, which is the maximum term for FCPR allégés.

Taxation

Investment vehicles

The Draft Finance Bill for 2009 contains provisions on taxation of income deriving from carried interest units held by the managers of FCPRs and SCRs (société de capital-risque, the other typical French investment vehicle). This will legalize, with new conditions, a regime that was only provided for by a French Revenue regulation: such income is in principle treated as wages and salaries but can be imposed at 31.1%, like capital gains, if:

- subscription price is at arm's length (no discount);
- investment of the managers in such units represents at least 1% of all subscriptions in the fund; and
- managers keep their units for at least five years.

Under certain conditions, the new regime will be extended to carried interest units held by French managers in funds created in most European Economic Area countries which have concluded a tax treaty with France containing an administrative assistance clause. This interesting development however excludes the French managers of offshore funds.

Structuring a French acquisition

Various changes are noteworthy, as they illustrate the current tendency of the French Revenue for a more pragmatic approach.

New thin capitalization rules entered into force in 2007 provide that:

- for loans granted by non-controlling direct shareholders, interest is deductible only up to a maximum rate published annually by the French Revenue; and
- for loans granted by related parties (i.e., entities controlling the debtor or controlled by the same entity as the debtor), interest is fully tax deductible to the extent loans (i) are at arm's length and (ii) do not exceed three alternative limitations to be assessed annually (in particular, 1.5/1 shareholders' debt-to-equity ratio).

Tax consolidation

A French parent corporation can consolidate its tax basis with those of its 95% held French corporate subsidiaries (including when such are held through EU interposed companies which are themselves 95% owned by the French parent, as ruled by the European Court of Justice a few weeks ago – *Papillon* Nov 27, 2008).

In an effort to facilitate the creation of tax groups in LBO transactions, an advance ruling dated November 18, 2008 confirms that the first expenses borne by the acquisition vehicle can be consolidated even though the 95% threshold in the target tax group is partly reached through the acquisition of a non tax consolidated French company.

Legislative, regulatory and tax law changes in Europe that affect private equity sponsors and hedge funds are likely to arrive.

The so-called "*Amendement Charasse*", which prevents the deductibility of interest expenses in a tax group where a target enters the group after being purchased from persons or entities which control the buyer, has been subject to various changes mainly favorable. In particular:

- for fiscal years opened as from January 1, 2007, the mechanism does not apply where the target is owned, even indirectly, by an entity which was acquired from a third party shortly before the sale in view of such sale. This is interesting for post-acquisition debt push downs in France;
- it applies over 9 years, rather than 15, from the date of transaction (moreover, it is suspended in case of change of control of the buyer).

However, it applies where the target does not enter per se into the tax group of the buyer but is merged into a member of such group.

Other comments

- New transfer tax rates apply since August, 2008: 3%, capped at EUR 5,000 per seller, on the transfer of stock of a corporation; no cap applies for shares of French LLCs and partnerships, and a 5% rate applies with no cap on shares of a French real estate entity (the French Revenue, despite recent case law, maintains such rate on shares of non French entities whose assets are mainly composed of French property).
- Withholding tax on interest: rate increased from 16% to 18% since January 1, 2008. A useful advance ruling dated January 8, 2008 confirms that the domestic exemption (which is subject to various conditions) also applies to interest paid to foreign banks upon syndication by a French initial lender.
- Withholding tax on dividends: since 2007, the French Revenue applies the Denkavit ECJ case law, therefore, French dividends paid to an European Economic Area parent locally subject to tax are exempt from withholding tax if the parent owns 5% or more for at least 2 years in the French company, and benefits from a local tax exemption on the dividends. This is a welcome change for French acquisitions made through Luxemburg holding

companies for instance, provided they are substantiated properly.

- Since 2007, acquisition costs must be amortized over 5 years (confirms practice).
- Post-Closing: in an advance ruling dated October 27, 2007, the French Revenue agreed not to question mergers made after a leveraged acquisition if it occurs within a tax group in the context of secondary LBOs, provided the merged entity is a wholly owned mere holding company (rather than an operating company with minority shareholders).

Stock exchange regulations

Prohibition of short selling shares of French financial institutions

On September 19, 2008, the AMF, after the Securities and Exchange Commission ("SEC") in the US and the Financial Services Authority ("FSA") in the UK, ordered a prohibition of non-secured transactions in 15 stocks of French financial sector companies and tightened transparency requirements concerning net short positions.

A working group has been created to conduct further analysis on the matter with a view to making proposals for measures to be adopted on a permanent basis.

Proposed changes of rules relating to the disclosure of major holdings and thresholds for mandatory takeover bids

In a report dated October 2008, a working group appointed by the AMF recommends in particular:

- creating a new minimum disclosure threshold fixed at 3% of the share capital or voting rights of the listed company (vs. 5% at present) and taking into account, in order to determine whether any threshold is reached, financial instruments that entitle the holder to acquire shares already issued (such as calls, puts, warrants, futures, forwards, bonds exchangeable in shares), as well as equity swaps; and
- lowering the thresholds triggering a mandatory offer to 20% or 25% (vs. one third at present) and to 1% (vs. 2% at present) for annual increases in shareholdings comprised between one third and 50%.

Following a public consultation, the AMF will take a position on these recommendations which would require changes to the existing legislation.

Prospective legislative developments

In a report dated November 13, 2008, a working group on the international financial crisis composed of members of the French Parliament made proposals for changes to the international financial system, including, on a European level:

- setting minimum transparency and valuation standards for hedge funds;
- creating a European status for LBO funds; and
- issuing recommendations on transparency of the remuneration of fund managers.

The above proposals are at a very early stage but indicate the direction of possible future legislation.

GERMANY

There are a number of legal initiatives in Germany applicable to private equity and hedge funds as a consequence of the financial markets crisis.

Ban on short selling

The German regulator (BaFin), following decisions of the SEC in the US and the FSA in the UK, issued a general decree banning short selling. The ban applies to shares in eleven listed German financial institutions and insurance companies including Commerzbank and Deutsche Bank as well as Allianz and Munich Re. The ban will apply until December 31, 2008 and is under constant review. Following the issuance of the German rescue package for financial institutions, it remains to be seen whether the ban will be extended beyond year end.

Restrictions on foreign investments

The German legislator is currently in the process of amending the German Foreign Trade and Payments Act (*Außenwirtschaftsgesetz*, *AWG*) to impose restrictions on foreign investments in Germany. The changes are expected to come into force in early 2009.

In summary, the law provides that any acquisition of 25% or more of voting rights in an entity resident in Germany by an investor (including private equity funds) resident outside the EU or EFTA states (Iceland, Liechtenstein, Norway, Switzerland) is subject to a post-signing review by the German Ministry of Economics and Technology.

In practice, the consequence of the law is that the sale and purchase agreement concerning the acquisition of the shares in a German entity must be made subject to the condition subsequent that the review of the Ministry is completed without the acquisition being prohibited. In practice, this could result in a delayed closing of the transaction or, if the transaction has already closed, in an obligation to unwind the transaction if the Ministry prohibits the acquisition within the three-month period for preliminary examination plus an additional two-month period for detailed examination following the submission of complete and detailed documentation by the purchaser.

Originally mainly meant to control investments of foreign sovereign wealth funds in German companies active in strategically critical areas such as defense, infrastructure and utilities, the law also applies to private equity and hedge funds. In practice, a prohibition of the acquisition will be issued only in very critical cases because the law has a very restricted scope of application and requires the endangerment of the public order and security of Germany for a prohibition of a transaction. In addition, the German Minister of Economics already issued a statement emphasizing that this law will only be applied restrictively so as not to hinder foreign investments in Germany.

German Social Democrats' initiative focusing on private equity and hedge funds

The German Social Democrats issued a report on October 27, 2008 titled "A new balance between market and state" laying the groundwork for new legislative proposals of the Social Democrats in the future. It is notable that also representatives of the Christian Democrats qualified the report as a good basis for further legislative discussions. The report specifically addresses private equity funds and hedge funds:

Private equity funds

- Restricted fundraising: German pension funds are to comply with the same restrictions on investments in private equity funds as insurance companies. Presently, pension funds can invest up to 10% of their restricted capital in "risk investments" whereas insurance companies are limited to 5%.
- Restrictions on financing: Introduction of additional limitations on excessive leveraged financing following the EU proposal to introduce rules prohibiting private equity investors to "misuse" their shareholder rights to strip portfolio companies of their assets (e.g., "recapitalizations and superdividends") resulting in disadvantages for the portfolio company, its employees, creditors and business partners.
- Employee participation: Participation of the portfolio company employees in exit profits of the private equity investor. It is proposed to reserve 5% of the exit profits for distribution to the employees.
- Taxation: Applying German trade tax to private equity funds. Details of such taxation are unclear, e.g., whether trade tax should be levied only on German private equity funds or also on offshore private equity funds.
- No income tax exemption: Abolishment of current income tax exemption under domestic law for major portion of capital gains. The current rules provide that 95% of capital gains from the sale of shares in a corporation by a corporate shareholder are exempt from taxation, i.e., only 5% of the capital gains are currently taxed at the applicable rate. In this context, it should be noted that for foreign investors, the German income tax exemption is not relevant if the respective investor qualifies for treaty benefits under a double taxation treaty. However, the new law could increase the substance requirements for such treaty exemption similar to the substance requirements already applicable to the taxation of dividends.
- Taxation of carried interest: Extension of German taxation rules for "carried interest" of private equity investors to other European countries (currently 60% are subject to German income tax).

Hedge funds

- Registration requirement: Obligation of hedge funds to register in the EU to avoid "offshoring" and subjecting such funds to supervision by regulatory authorities.
- Disclosure: Obligation of hedge funds to disclose asset and ownership structure, ongoing transactions and increased disclosure requirements regarding risks for fund investors.
- No access to public markets: Access to public markets for hedge funds to be prohibited.
- Code of conduct: Hedge funds to be bound by a mandatory code of conduct.
- Taxation: Appropriate taxation of profits of hedge funds to be ensured.
- Limitation for financing: Requirement for financing institutions to provide for a regulatory equity basis of at least 40% when extending financing to hedge funds; this is five times higher than the current Basel II requirement.

Guidelines of German Private Equity and Venture Capital Association

Following repeated requests for transparency of private equity funds, the German Private Equity and Venture Capital Association issued guidelines for disclosure and transparency of private equity firms and portfolio companies. The guidelines were in fact published immediately prior to the Social Democrats issuing their request for more transparency on the financial markets. Members of the association include inter alia Bain Capital, The Blackstone Group, Carlyle Group, Goldman Sachs, KKR and TPG Capital as well as a number of leading European private equity firms. The guidelines are structured in analogy to the German Corporate Governance Codex applicable to listed stock corporations, i.e., deviations from the guidelines may be made by applying the "comply or explain" rule. In addition, the guidelines provide for communication rules, for the obligation to disclose financial information, the disclosure of portfolio companies of a private equity investor, public reporting requirements as well as for the disclosure of the relationship between the private equity companies and their investors. The applicability of the guidelines is, however, limited by the fact that it only relates to large buy-outs and to companies organized under German law having an enterprise value of more than EUR 750 million, generating more than 30% of its turnover in Germany and employing more than 1,000 employees on a fulltime basis in Germany.

UNITED KINGDOM

Prohibition on short selling shares of UK financial institutions

In September 2008, shortly after the SEC ban order was introduced on short sales on selected US financial institutions, the FSA established new rules prohibiting investors from initiating new or contributing to existing net short positions in certain prescribed UK financial sector companies, amounting to 34 stocks as at September 30, 2008. The provisions, contained in the FSA's Code of Market Conduct ("MAR"), also require daily disclosure of all net short positions in excess of 0.25% of the ordinary share capital of the relevant companies held at market close on the previous working day (and disclosure if a previously disclosed net short position falls below the 0.25% disclosure threshold). These provisions cease to have effect on January 16, 2009, although they are kept under review. Market makers are exempt from the provisions. The impact of these measures has brought many managers' strategies into question, at least with respect to the financial sector.

Expanded requirement to disclose interests in shares

In July 2008, the FSA published an update on the results of its consultation on the disclosure of economic interests in shares held through derivatives such as contracts for differences ("CFDs"), concluding that long CFD positions must be aggregated with shareholdings and disclosed at a 3% holding level. Final rules relating to this issue are to be published in February 2009 and implemented by September 2009 at the latest.

This decision follows the FSA's amendment to MAR to require the disclosure of short positions of 0.25% of an issuer's share capital where the issuer's securities are admitted to trading on a prescribed market and where the issuer is undertaking a rights issue.

The hedge fund industry and, indeed, any holders of interests in publicly listed securities in the UK should be aware of the following, breach of which can lead to an enforcement action by the FSA:

- 3% and greater holdings (and certain changes in those holdings) in voting rights (direct or indirect) must be disclosed (Disclosure and Transparency Rules);
- dealings in securities of any company which is the subject of a takeover offer, or possible offer, by any person who holds gross long interests (including through CFDs or other derivatives) in 1% or more of those securities must be publicly disclosed (Takeover Code, Rule 8);
- dealings through CFDs in securities of any company by a potential bidder for that company will likely constitute market abuse, even where the exposure is purely economic (MAR 1.3.2 (3));
- open net short positions of 0.25% or more of any company listed on a prescribed market (which does not include AIM) and which is undertaking a rights issue must be disclosed (Short Selling Instrument 2008); and
- with effect from September 2009 at the latest, long CFD positions must be aggregated with shareholdings and disclosed at a 3% holding level.

Limited exemptions to the above rules are available to certain types of market participant; for example, market makers.

Prime brokerage arrangements – risk management concerns

Following the demise of Lehman Brothers, previously "standard" prime brokerage arrangements have recently become the focus of funds and investors. Standard industry prime brokerage agreements are generally produced by the prime broker and thus tend to deal only with protection of the broker in the event of a failure of its customer. However, the position of the customer in the event that the broker itself gets into difficulties is generally more complicated and a number of issues fall to be considered given the current credit quality of certain prime brokers, particularly:

Protection of customer assets: are customer assets ringfenced if the broker is insolvent? How does the broker hold assets, including collateral assets, of its customer? Are they segregated in dedicated client accounts, or does the broker take title to such assets and hold them in its own name?

Excess collateral: how is over collateralization for margin calls dealt with? How often and on what basis is excess collateral returned and does the customer have the right to call for its return and in what circumstances?

Use of collateral: many brokers reserve the right to use (or "rehypothecate") collateral assets for their own purposes (e.g., as collateral for their own liabilities, stock loan settlement etc.). In the case of Lehman Brothers, these provisions have already lead to legal action being taken by RAB Capital against PricewaterhouseCoopers, the administrator of Lehman Brothers in London, to recover $50 million (£27 million) of assets frozen when Lehman Brothers, prime broker to one of RAB Capital's funds, was put into administration.

Insolvency of broker: express contractual provisions dealing with this eventuality are rare, and the applicable insolvency laws and the likely consequences for the customer may not be clear.

The question in the current environment is whether brokers will be prepared to renegotiate the terms of their prime brokerage agreements – and if so, at what cost.

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