

Opinion Leaders

NOVEMBER 2008

N°7

In this month's issue:

Editorial	1
Legal and Text Watch	2
Recent Legal Advice and Key Deals – Upcoming Conferences	9



Daniel Schmidt
Partner

Corporate / Private Equity / Financing

EDITORIAL

Autumn leaves

Just as leaves fall off trees, amendments and legal texts swirl in all directions and cover every lawyer's desk.

The contractual FCPR, an essential update to the French private equity vehicles in order to keep them leveled with international standards has been published with an FAQ by the French Financial Market Authority which, could have because of its nature jeopardized its survival immediately following its birth: this fund which was not intended to be limited to any ratio other than the ones freely negotiated between the management company and the investors, was about to be attached with a quasi-investment ratio amounting to 100% in non listed companies.

At the same time, the order of 23 October 2008, gives a new dimension to contractual UCITS other than FCPRs. These UCITS can invest in all types of "products", therefore including debt securities, while contractual FCPRs were not authorized to do so or, as debt securities are concerned, such possibility will be strictly limited. As a result, will the contractual FCPR be obsolete when it has just been formed?

This order enables Funds, and as far as we are concerned, Hedge Funds and FCPI/FIP, to confine their liquid assets in side pockets by following a simplified procedure. Here is a text drafted at the ^perfect season!

But the most incredible text produced this fall concerns, without any doubts, the carried interest. Sorry, to actually use the right and official terminology, I should say the "bonus". In his endeavor to "run after" LBO operators, Senator Jean Arthuis has indeed succeeded in having an amendment adopted, such amendment not being definite at the time of this newsletter. The amendment would toughen the conditions granting carried interest in such proportions that they would be unworkable for the great majority of venture capital or capital development funds, or even for low or middle buy out funds. Let us hope that with winter approaching, this text will not be frozen in its actual version and that an Indian summer will allow some flexibility to bloom.

As is the case every year, fall is decidedly a difficult season for private equity regulation.

French Law on Modernization of the Economy (LME) update

Under the powers granted to it by the Law on Modernization of the Economy (*loi de modernisation de l'économie*) adopted this summer, the government has launched a number of interesting reforms, particularly in the area of financial regulations and competition law.

- **Financial regulations**
 - ***Asset management for third parties***

The order of 23 October 2008 reforming the framework for asset management for third parties is the result of the work of the Financial Market High Commission (*Haut Comité de Place*) established a year ago by Christine Lagarde to strengthen the attractiveness of French financial markets.

This order concerns **all UCITS** whether in the form of funds (FCP) or open-ended investment companies (SICAV). Henceforth, these entities may produce their documentation in a single language which need not be French provided the language selected is understandable by its target investors. Up until now, this exception was granted only for certain Funds (contractual UCITS, simplified FCPRs etc.).

Further simplification was introduced by eliminating the requirement to appoint a deputy auditor.

Finally and above all, these funds are authorized to transfer some of their assets whose disposal would not be in the interest of their investors to a new vehicle of the same form (SICAV or FCP). This transfer, which may be undertaken in the form of a spin-off, is authorized whenever exceptional circumstances and the interest of shareholders require. The decision is made by the extraordinary shareholders' meeting of the SICAV or the FCP management company. It does not require authorization by the AMF. Instead a simple declaration is required. Each shareholder or unit-holder receives a number of shares or units of the entity created equal to those it held in the spin off entity. This use of "side pockets" provides Funds attaining the end of their term a solution that has been demanded by professionals to liquidate their portfolios. In this way, fund managers will not force to dispose of illiquid assets still held by the Fund at fire-sell prices.

The order considerably relaxes the provisions imposed for **contractual UCITS** by article L.214-35-2 of the Monetary and Financial Code ("CMF"). Henceforth, these funds, as an exception to the rules that apply to UCITS, may hold "products" and no longer exclusively financial instruments, bank deposits and liquid assets. In consequence, under certain conditions, they should be able to invest in movable and immovable property (without this property being securitized) and even to hold certain rights in personal or intellectual property rights..... We hope that lawmakers will finally have the good idea of extending this option to contractual FCPRs ! Finally, these contractual UCITS are legally authorized as FCPRs, to grant the management company a portion of liquidation proceeds. This should make it possible to issue shares very similar to those entitled to carried interest in FCPRs without however falling under the scope of the 2002 French tax instruction.

Finally, recent changes have been made concerning the **marketing of foreign-law funds**. It will be recalled that since 1 November 2007, following the implementation of the MiFID Directive, rights representing a financial investment in an entity issued on the basis of foreign law such as shares of Limited Partnerships, are henceforth considered under the law as financial instruments. However, the AMF has indicated that these rights may not necessarily be freely marketed (through public offerings or private placements). In a press release issued last April, it indicated that "open-ended" vehicles in which shareholders may require the redemption of shares by the entity may not be marketed until authorization by the AMF. In contrast, "closed-ended" vehicles may be marketed under rules applicable to public offerings or private placements. The above-mentioned order sets forth the AMF's position on "open-ended" funds whereby the latter constitute UCITS that are marketable in France after prior authorization by the AMF.

- Others financial matters

The *Haut Comité de Place* has also developed draft legislation recently or soon-to-be published. These proposals cover:

- **Disclosures on regulated markets** (information concerning material holdings in listed companies, declarations of intention and issuers whose securities are admitted for trading on a regulated market) ;
- **Market making agreement** (elimination of the obligation of transferring to registered form repurchased securities) and disclosure rules governing **share buybacks** (simplified disclosure rules) ;
- **instruments financial instruments** (settlement of conflicts in law, indexation of debt securities and forward financial instruments, definition of participants in interbank settlement system or settlement-delivery systems for financial instruments, auctions for government bonds and negotiable debt securities) ;
- **public offerings;**
- **preferred shares.** The order of 6 November 2008 notably provides that preferred shares not carrying voting rights when issued do not carry preferential subscription rights.

■ Competition law

On 13 November 2008, an order was issued on the modernization and regulation of competition practices. This reform at least in part eliminated the French system based since 1986 on shared jurisdiction between the Minister of the Economy and the Competition Commission. Henceforth, the *Autorité de la Concurrence*, an independent administrative authority will be responsible for oversight of antitrust and anticompetitive practices. The procedure applied will be better organized to distinguish more clearly the different phases of the investigation and review process for issuing the decision.

Finally, orders concerning bankruptcy protection and intellectual property laws are expected in early 2009.

Legal News

Adoption of the law on earned income

This law, announced well before the summer by the President of the Republic introduces reforms for voluntary profit-sharing schemes (instituting a tax credit to adopt voluntary schemes, etc), mandatory profit-sharing schemes (freedom of choice by the employee between the option of immediate and deferred access to income associated with mandatory profit-sharing schemes, extension to heads of companies with less than 50 employees and their spouses if they are employees or partners, etc) and stock options (grants in listed companies are subject to the proviso that the company granted stock options or bonus shares to all employees and at least 90% of all employees of its subsidiaries or the existence of an agreement for an exceptional or incentive plan, exceptional or voluntary profit-sharing scheme in favour of at least 90 % of all the employees of its subsidiaries).

In the area of an employee savings plans, it may be regretted that the joint Parliamentary committee (*Commission Mixte Paritaire*) in the end withdrew its text that subjected certain employee savings funds to a procedure for simplified filing rather than a requirement to obtain prior authorization. This concerned employee savings funds, invested in shares of midsized (less than 500 employees unlisted companies).

This law should be issued in the coming days.

Sovereign funds

On 20 November, Nicolas Sarkozy announced the launch of a French sovereign fund to serve as a vehicle for major interventions whenever a strategic company has a need for capital. A subsidiary of the CDC (*Caisse des Dépôts*), it will have funds of €20 billion in 2009: €14 billion will come from the pooling of State minority interests and all the strategic shareholdings of the CDC, with the remaining €6 billion to be provided by the State and the CDC through debt.

The fund is destined to acquire only minority interests for periods of two to ten years, to strengthen the position of companies unable to obtain on the market liquidity required to finance their development and safeguard the capital of strategic companies. The Fund will be chaired by the current Chairman and Chief Executive Officer of the CDC, Augustin de Romanet.

IPEV press release on fair value

In response to positions recently adopted notably by the SEC and the AMF, the International Private Equity and Venture Capital Valuation Board (IPEV) reaffirmed its commitment to fair value that it considers to constitute the best measure for valuing private equity portfolio companies and investments in private equity funds. It nevertheless noted that fair value should not be used as the sole factor in assessing the performance of investment managers. Finally, it encouraged all professionals and particularly investment managers to apply the fair value method with greater rigor.

For further information:

http://www.privateequityvaluation.com/documents/IPEV_Committee_Statement_v3_181108.pdf

European news

Taxation of savings: The European Commission proposes modifications to eliminate tax evasion

The European Commission recently adopted an proposal amending the Savings Taxation Directive with a view to closing existing loopholes and to eliminating tax evasion. Since 2005, the Savings Directive ensures that paying agents either report interest income received by taxpayers resident in other EU Member States or levy a withholding tax on the interest income received.

The Commission proposal seeks to improve the Directive, so as to better ensure the taxation of interest payments which are channelled through intermediate tax-exempted structures. It also proposes to extend the scope of the Directive to income equivalent to interest obtained through investments in various innovative financial products as well as in certain life insurances products. Moreover, simplification of the technical operation of the Directive should lead to a more user friendly system and a more efficient implementation.

Tax news

The National Assembly adopts the 2009 Finance Bill...

The Finance Bill was adopted on 19 November by the National Assembly. It limits the amount of tax exemptions offered by certain **tax shelters** to €25,000 per year, increased by an amount corresponding to 10% of taxable income. The tax shelters concerned include notably the tax reduction for cash shares in companies (more commonly known under the name of the "Madelin" reduction) and shares of innovation investment funds (FCPI) and local investment funds (FIP) shares. If this measure is adopted by the Senate, it will apply to investments or subscriptions of shares starting 1 January 2009. It should be noted however that it concerns only tax allowances granted for income tax and not those granted in connection with the wealth tax (such as investments in SMEs through holding companies or investment funds).

In this respect, we note that the amendment restricting the investment strategy for holding companies eligible for wealth tax reductions ("**holdings ISF**") adopted by the Finance Commission, was ultimately not accepted. This amendment required these holdings to invest at least 60% of their net equity in companies in the seed and start-up phase of less than 10 years and recognized as such by OSEO, the French agency for innovation.

... currently under review by the Senate ...

In the session of 24 November, the Senate adopted the amendment filed by Mr. Jean Arthuis, Finance Commission Chairman, on the **tax provisions applicable to carried interest**. As a result income and gains from the shares continue to be taxed as capital gains (article 150-0 A of the CGI) provided notably that the following provisions are met:

- Carried interest shares must have been acquired for a price corresponding to the value of said shares,
- Carried interest shares representing at least 1% of the total subscriptions in the Fund or Company or a lower percentage fixed by decree in the case of FCPIs and FIPs ,
- The amounts or values to which these carried interest shares confer rights are paid at least five years after the creation of the fund or the issuance of the shares and for shares of FCPRs, after repayment of the contribution of other shareholders.

The other conditions, that were set forth in the instruction of March 2002 (related to the fact that (i) carried interest must represent a single category of shares, (ii) the transferor must not hold other shares of the same fund or the same venture capital entity or for which it benefits from income tax exemptions and (iii) receives normal compensation under its employment contract or for his or her appointment as a corporate officer) are maintained.

If these conditions are not met, income and gains are taxed as additional employment income.

It should be noted that the lawmaker has expanded the provisions to employees of investment entities whose purpose is to invest in unlisted companies and are incorporated in a Member State of the European Union or another State party to the agreement on the European Economic Area having concluded a tax treaty with France that contains a provision to provide administrative assistance to combat tax fraud or tax evasion.

If confirmed, most of the provisions adopted would apply to shares and rights issued starting 1 January 2009. Finally, the entire system will apply to FCPR venture capital funds created as of 1 January 2009.

... and discusses the revised 2008 Finance Bill

Presented at the close of the Council of Ministers on 19 November, the revised 2008 Finance Bill presents four major priorities:

- Support the economy and businesses by introducing a permanent relief of the business tax for the rental value of new equipment and property acquired by companies between 23 October 2008 and 31 December 2009 ;
- Improve the legal and fiscal security of taxpayers involving notably a reform of the procedure concerning the abuse of law and improve advance tax ruling;

- Measures for combating tax fraud, and notably tax havens, by extending the duration of the time limit to six years and increasing the amount of fines imposed for nondisclosure of bank accounts;
- Sustainable development.

AMF news

Chairmanship of the AMF

Mr. Jean-Pierre Jouyet, will soon leave his functions as Secretary of State for European Affairs to assume the chairmanship of the AMF starting 15 December of this year, thus replacing Mr. Michel Prada.

Highlights of the AMF report on asset management for third parties in 2007

France has a market share of 19% for the domiciliation of UCITS, just behind Luxembourg (26%) but ahead of Germany (13%), the United Kingdom (10%) and Ireland (10%). It also occupies second place for discretionary portfolio management for individual investors (18% market share) though well behind the United Kingdom (49%).

In terms of market participants, in 2007 the AMF licensed 52 portfolio management companies compared with 42 in 2006 (+24%). Most (56%) were licensed to operate in a specific area: 59% for private equity, 38% for real estate management. Only 21% of the new management companies were licensed to manage "traditional" financial instruments. Finally, for the remainder, 38% of management companies have a program of operations for private equity, 18% for the management of contractual UCITS, 17% for indirect alternative management, 14% for employees savings, 9% for leveraged funds subject to simplified investment rules (*OPCVM ARIA*) and 4% for real estate investments.

In terms of products, at the end of 2007, the AMF counted more than 7,000 FCPs, 2,800 FCPEs, 876 FCPRs (including 376 licensed funds and 470 simplified funds) and 746 SICAVs.

Contractual FCPRs : the AMF presents its position and develops guidelines for updating programs of operations for funds

At a conference organized in partnership with the AFIC and AFG, the AMF presented its position on contractual private equity funds (contractual FCPRs). This position is set forth in the document “*Answers to questions on the creation of contractual FCPRs*”, available in French on its website:

http://www.amf-france.org/documents/general/8549_1.pdf

At this conference, the AMF noted that management companies licensed for private equity must, before creating contractual FCPRs, update their program of operations. In practice this involves presenting the proposed dispensations and specific characteristics of the contractual FCPR in relation to products already managed by the portfolio management company. For this purpose the AMF has developed standard guidelines which can be consulted on its website:

http://www.amf-france.org/documents/statique/fr/formulaires_ppe/Trametype_FCPRContractuel.pdf

It also indicated that assets not expressly eligible for inclusion in contractual FCPRs will soon be defined by the AMF. In addition, the percentage of assets of the contractual FCPRs that may be invested in debt securities will be established by a decree that may fix a maximum amount of 15%. Finally, a meeting should be planned with professional associations to discuss the possibility of a feeder contractual FCPR fully invested or almost entirely invested in a foreign fund (Limited Partnership...).

Updating FCPRs instructions

The COB instructions of 6 June 2000 on licensed and simplified FCPRs needed to be updated. To this purpose, the AMF created a working group of professionals to develop future instructions. These have currently been submitted for consultation. The principle of two distinct instructions, one for licensed FCPRs (including FCPIs and FIPs) and the other for simplified FCPRs has been maintained. These instructions deal with the licensing or filing procedure for this category of funds, modifications to be made during its lifespan and shareholder disclosure procedures.

Recent Legal Advice and Key Deals– Upcoming Conferences

Recent Legal Advice and Key Deals:

- Extension of a portfolio management's program of operations;
- A dispute between a FCPR shareholder and a management company,
- Audit/review for an investor of the bylaws of a SICAR venture capital fund,
- Audit/review for an investor of the bylaws of a FCPR venture capital fund,
- Implementation of a method for calculating the ratios of a venture capital fund eligible for potential tax exemptions (*FCPR fiscal*),
- Advice on the eligible activities for holding companies qualifying for wealth tax reductions ;
- Adaptation of management packages,
- Application before the Administrative Court for a venture capital company subject to a tax deficiency adjustment for the minimum business tax contribution,
- Advice on the scope of the obligation to classify customers,
- Scope of local advertising regulations completing regulations applicable to advertising and public notices
- Legal and tax reorganization of a group of companies,
- Implementation of a share buyback program and market making agreement;
- Adhesion to an implementation of the AFEP - MEDEF recommendations on compensation of executives and officers;
- Review of a Corporate Governance Charter and compliance measures;
- Presentation of a comparative review on contractual practices in French and US law,
- Advice on international legal cooperation and analysis of mutual legal assistance with France,
- Drafting brokerage agreements for the establishing of business relations between the sellers of companies and a potential buyer
- Analysis of liability clauses in agreements for international joint ventures.

Upcoming conferences:

- **TEPA conference:** "*Transforming wealth tax into capital for SMEs ...*" - 21 January 2009 at the French Senate - Proskauer Rose is a partner of the event - Intervention of Daniel Schmidt.

Corporate / Private Equity / Financing

For more information about this practice area, contact:

Daniel Schmidt
33.1.53.05.60.00 – dschmidt@proskauer.com

Florence Moulin
33.1.53.05.60.00 – fmoulin@proskauer.com

Publication E-mail: leaders.dopinion@proskauer.com

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion.

BOCA RATON | BOSTON | CHICAGO | HONG KONG | LONDON | LOS ANGELES | NEWARK | NEW ORLEANS | NEW YORK | PARIS | SÃO PAULO | WASHINGTON, D.C.

www.proskauer.com

© 2008 PROSKAUER ROSE LLP. All Rights Reserved. Attorney Advertising.