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Infrastructure: Market overview

Infrastructure has been experiencing phenomenal growth for several years now.

Infrastructure assets are usually defined as those addressing basic requirements or providing services related to our essential needs. They are fundamental services on which a community's growth and development depend, particularly transport and communications systems (airports, freeways, toll bridges, etc.) as well as water and electricity providers.

Infrastructure has traditionally been entirely financed by the public sector. Then, under increasing budgetary pressure, governments began to rope in private sector support. A gradual transfer of infrastructure financing to the private sector then occurred, especially through public-private partnerships (PPP), directly inspired by the British Private Finance Initiative (PFI) model, which enabled the emergence of infrastructure funds.

Keen interest from private and institutional investors in this asset class has remained constant ever since.

Despite some structural changes related to the credit crisis in summer 2007 and the corresponding reduction in debt, these assets continue to represent a definite appeal for investors.

Unlike private equity, in which the gain is obtained on withdrawal, investment in infrastructure provides investors with a high regular yield.

This asset class also offers protection against inflation to the extent that infrastructure management companies – especially for assets that are regulated or under contract, such as electricity or water distribution – generally benefit from indexation to inflation, which tends to protect investors against a rise in consumption prices. This represents an obvious advantage during periods of market crisis.

These assets are therefore mainly aimed at investors looking for long-term transparency of cash flows who are ready to forego liquidity in their investments.

Yet, if we consider the various legal forms for infrastructure funds that exist in France, we notice that investors in France can currently invest in this sector mainly, but not exclusively, through contractual funds (*OPCVM contractuels*).

Institutional investors also turn to private equity funds dedicated to this asset class. These are simplified FCPRs, private equity funds governed by article L.214-37 of the French Monetary and Financial Code (CMF). However, FCPRs face two issues not especially compatible with infrastructure assets, namely a ban on borrowing more than 10% of their assets and a freeze on buyback and withdrawal requests by investors for a maximum period of 10 years.

Contractual FCPRs were recently created by the French Law on Modernization of the Economy of August 4, 2008 to strengthen Paris's competitiveness as a financial centre, and tackle competition, particularly from limited partnerships (under English and Delaware law). Nevertheless, these FCPRs, whose status is set out in article L.214-38-1 of the CMF, remain vehicles dedicated to private equity investment, even though they benefit from flexible functional and structural rules.

Despite their recorded returns, this asset class is still very rare in institutional investors' allocation.
Paradoxically, infrastructure needs are constantly growing, both in the developed as well as the developing and emerging economies. Furthermore, governments are increasingly turning to the private sector to finance and develop projects, which will further open up this asset category to investors.

Insurance companies, who are long-term investors, are showing growing interest in this asset class. This makes insurance companies' understanding of infrastructure in the allocation of their savings crucial.

Nonetheless, investors, and especially insurers, are subject to regulatory constraints on distribution and dispersion of investments in order to spread risk.

Remember that due to the time delay between the moment when the insurer receives the premiums and the moment it pays out for claims or services, the insurer has sums available which it can invest in financial markets.

For very obvious reasons of security and protection of policyholders, legislation sets out certain framework rules for these investments which must meet three characteristics: security, liquidity and profitability. It is then up to the insurer to seek a compromise between the three.

Here are some key ideas to note concerning the rules for asset distribution and dispersion:

- listed bonds may be included without any limit. Maximum dispersion per issuer is 5% or 10%. However, non-listed bonds do not appear to be eligible;

- listed shares may compose up to 65% of the asset. Maximum dispersion per issuer is 5% or 10%;

- loans granted to companies are only eligible under certain conditions and up to 10% of the asset. In particular, beneficiary companies must have registered office within an OECD member state. Furthermore, except for some loans granted to companies whose shares are traded on a recognized market, loans must be accompanied by guaranties.

- non-listed securities, FCPRs or contractual UCITS may not come to a combined total of more than 10% of the asset; maximum dispersion per issuer is 1%. This ratio, commonly called a "ratio poubelle", is apparently designed to accept infrastructure funds according to their general definition.

Institutional investors are therefore currently able to allocate a maximum of 10% of their investment to a range which already includes numerous assets and in particular a proportion of simplified-procedure FCPRs and contractual UCITS which are explicitly eligible according to the “ratio poubelle".

On the other hand, no amendment has yet been made to explicitly target contractual FCPRs.

It will probably be in the government’s interest to further encourage institutional investors to finance the construction of new infrastructure and/or renew ageing infrastructure and so develop regulations in this direction.

News

The Arthuis amendment to FCPI and FIP investment deadlines and the capping of costs and commissions was passed by the Senate. But with a new exception for FCPIs.

As feared by professionals, the proposed Arthuis act on investment deadlines for FCPIs and FIPs resurfaced in the 2010 Finance Bill. Its author introduced the text of his proposed law as an amendment. This resulted in its overdue examination by the National Assembly. As is discreetly stated in the outline of its reasons for being proposed, "*the purpose of this amendment is to take up the terms of the proposed law …passed by the Senate on June 29, 2009, which the restrictions of the parliamentary calendar made it impossible to schedule for debate by the National Assembly."*

The amendment adopted on November 24 is very close to the text adopted in June by the Senate.

➢ **<u>What will the consequences be for funds?</u>**

- **Income tax FCPIs**

- "Income tax" FCPIs will have **six months to achieve 50% of their investment quota** (i.e. a 30% ratio of innovative companies) **and 12 months to achieve the rest** (i.e. a 60% ratio).

  These deadline periods begin (i) either from the fund subscription closure date, (ii) or six months after the 2010 Finance Act is passed.

  (i) The six and 12 month deadline periods therefore start from the end of the subscription period. This may be extended beyond the Fund’s creation date (i.e. the date the funds are declared deposited) but within a maximum period of eight months. Nothing therefore seems to prohibit subscription periods of more than eight months: This is because to create the fund, at least 400,000 euros must be collected… so the subscription period must have begun beforehand.

  E.g.: an FCPI’s subscription period runs from February 1 to December 31, 2010. On September 1, it has received more than 400,000 euros and requests its depositor to produce a declaration marking the Fund’s creation date. It has an overall subscription period of 11 months, with four months running after its creation. This FCPI must therefore have a ratio of 30% innovative companies by June 30, 2011, and a ratio of 60% by December 31, 2011 at the latest.

(ii) But the six and 12 month deadline periods may also run six months after the Finance Act has been passed, since a Finance Act must be passed by December 30 at the latest. Let us suppose that the Finance Act is published on December 31, 2009. The 30% ratio must be met by December 31, 2010, at the latest and the 60% ratio by June 30, 2011. Which Funds may be affected? Neither the text nor outline of its reasons for being proposed clearly state this. Perhaps Funds whose subscription period is open on the date the Act is passed. In this respect, it would seem crucial to ensure that the future reform does not impact Funds already created.

- **An exception is included for FCPIs whose purpose is to invest more than 50% of their assets in the share capital of JEIs (young innovative companies)**. These will continue to benefit from a period of two financial years (i.e. up until 30 months, if the first financial year is 18 months) to achieve their ratio. But the innovative companies defined are not those certified by Oséo-innovation and theoretically eligible to FCPIs.

  They are JEIs, i.e. SMEs (less than 250 employees and TO < €50m or balance sheet total < €43m), created less than eight years ago, excluding as part of a merger or restructuring, which have invested research expenses of more than 15% of tax deductible expenses and whose capital is mostly owned by individuals or certain legal entities (SCRs, FCPRs).

  This exception was introduced to take account of the constraints related to this investment policy "*which may require longer periods for analysis of files*". To take advantage of this exception, will the companies involved simply need to meet the conditions to enjoy JEI status or will they need to have formally opted for that fiscal status? Reading the text leads us to believe that the company will not need to have opted for that status. Must JEI conditions be met at the time of the initial investment or throughout the duration of the FCPI investment? This must, as necessary, be specified in the instruction. In any case, this exception may be very useful for FCPI managers.

- **Income tax FIPs**

- Although there appears to be no doubt as to Senator Arthuis's desire to reduce FIP investment deadlines, it should be highlighted that in its current state the wording of the text will not extend the new rules to FIPs. This is because the draft text on FIPs refers back to a text mentioned in article L.214-41 of the CMF. But that article only applies to FCPIs.

- Finally, in the event that the text is corrected to expressly cover FIPs, it should be noted that the exception concerning investment in JEIs is difficult to reconcile with FIPs' investment requirements. In other words, FIPs are not made an exception.

- **Wealth tax relief funds**

- Wealth tax relief funds, whether in the form of FCPRs, FCPIs or FIPs, all have their investment deadlines reduced in the same way. It should be noted however that they have 12 months to reach both their investment ratio in eligible SMEs and their 20% or 40% ratio (as relevant) in eligible SMEs created in the last five years.

- Fees and commissions will be capped at an amount set by ministerial ruling. Quite surprisingly, this cap does not cover income tax FCPIs and FIPs.

- **Common penalties**

In the event of failure to comply with the investment ratios within the deadlines set out above, the fund management company is liable for a penalty equal to 20% of the investment amount needed to reach half or all of the ratios, as applicable.

➢ **<u>What will the consequences be for wealth tax holding companies?</u>**

They are two-fold:

- they must now produce an information document for their potential investors. The document was already required, but only for those making public offerings (prospectus).

- they must also comply with a fees and commissions cap which will be decreed by the finance minister.

➢ **<u>What will the consequences be for other vehicles?</u>**

Apart from wealth tax FCPRs, FCPRs are not covered.

➢ **<u>More information: update on the legislative procedure</u>**

Having been subject to a formal vote by the Senate around December 8, the Finance Bill must be sent to the joint parliamentary committee, which is due to adopt a more or less definitive text around December 15. The text is then put to the vote in both chambers. Finally, like all Finance Bills, the text must be adopted by December 30 at the latest and published on December 31.

Business tax: SCRs and investment holding companies

➢ **<u>An expanded field of application due to the lowering of the liability threshold</u>**

The 2010 Finance Bill reforms professional tax and plans to replace the CMTP (minimum business tax contribution) due by companies which achieve turnover of more than **7.6 million** euros with a contribution based on value-added due from those with turnover of more than **500,000 euros.**

➢ **<u>Making the tax progressive</u>**

While the CMTP was not progressive since its taxation rate was 1.5%, the contribution based on value-added **increases according to the value-added** produced by the company.

➢ **<u>Rules specific to SCRs and investment holding companies</u>**

Companies whose main activity is managing financial instruments (other than credit institutions, investment companies and insurance companies, etc.) will now have specific rules applied, whereas they were previously treated as credit institutions. This mainly involves SCRs and holding companies.

- **Definition of companies whose main activity is managing financial instruments**

Principle

These are companies which fulfil at least one of the following two conditions:

- The fixed assets and investment securities owned by the company represented an average of at least 75% of the financial year's assets;
- Turnover from the financial instrument management activity generated by financial profits and profits from the sale of securities achieved during the financial year is higher than the total turnover from other activities.

Exception applicable to banking and insurance subsidiaries

The text does, however, provide a limit for **subsidiaries of banking and insurance groups**. For in companies of which at least 50% of the voting rights are held, directly or indirectly, singly or jointly, by an investment company, a credit establishment, a mutual insurance company, a provident company, an insurance or a reinsurance company, the conditions mentioned in the two previous paragraphs are assessed in respect of the asset and the turnover of the group to which the company belongs, **based on the consolidated accounts.**

- **Determination of the turnover governing liability for the additional contribution**

For companies whose main activity is managing financial instruments, the text stipulates special rules to determine their turnover. These include:

- the turnover as it is determined for most companies,
- financial products, excluding draw-down on provisions for depreciation on securities and 95% of dividends from equity investments and shares in related companies,
- profits from the sales of securities, excluding value-added from the sale of equity investments.

Therefore 95% of dividends and 100% of value-added from sales relating to **equity investments** are not taken into account to calculate turnover. This notion of "equity investments" is not defined by the text, which is the crux of the problem. Are these equity investments in the accounting sense or in the sense of article 219 a quinquies of the CGI (French Tax Code)? If the latter is the case, equity investments of this type from an accounting perspective (defined above) as well as securities giving entitlement to the parent companies tax regime (securities held for at least two years in a company whose SCR owns 5% of the share capital) would be intended.

Although the text of the law is of no help, the finance committee's report states that *"the definition of equity investments is **in line with the accounting definition** and has been set out in the authoritative literature. These are therefore securities whose long-term possession (generally longer than two years*[1] *is deemed useful to the company's activity, particularly since it makes it possible to exert an influence*[2] *over the issuing company or control it*."

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[1] *The aim of achieving a short-term profit is absent or incidental. Securities held for a short period to achieve a profit, which are therefore part of a more speculative policy, must be categorized in the investment securities portfolio.*

[2] *i.e. the effective investment in the management and financial policy of the issuing company. Assessment of the level of investment in the capital depends on individual circumstances.*

- **Determination of the value-added on which the additional contribution will be based**

Once the SCR achieves a turnover, as defined above, of more than 500,000 euros, it is subject to the contribution assessed on the value-added produced by the company which is equal to the difference between:

- the turnover as defined above and
- external services, financial expenditure, excluding allowances for amortisation and provisions for depreciation of securities, and expenditure on sale of titles other than equity investments.

The text adopted by the National Assembly has also been approved by the Senate. It can therefore be considered to be almost definitive. Many SCRs and holding companies are therefore likely to be liable for this contribution from 2010.

Wealth tax holding companies: maintenance of the 50-shareholders cap

The Forissier amendment adopted when the Finance Bill was examined by the National Assembly was **rejected by the Senate.** This amendment aimed to raise the cap restricting the number of a wealth tax holding company's shareholders to 50, under certain conditions (investments in companies less than 10 years old, with less than 50 employees and whose annual turnover was less than or equal to €10m).

Carried interest

As we have previously indicated, distributions and net gains relating to:

- units of carried interest from FCPRs created since January 1, 2010, and
- shares and carried interest rights in SCRs and entities, issued since the same date

shall be subject to a **specific employee contribution** of 30% if the carried interest units, shares and rights do not comply with the "Arthuis" conditions.

Since this contribution is "exempting", it should exempt all employee charges due on income from property (CSG, CRDS, etc.), which is currently set at 12.1%. It will be based on total distributions and net gains, before income tax. An increase of 10% will be due if the contribution is not paid within 30 days of its due date.

This contribution will be due from the employee or director who receives the carried interest.

Finally, the entities (portfolio management companies, SCRs, service providing entities and companies) which employ one or more employees who have benefited from a distribution resulting from carried interest units, shares or rights (or who are directed by somebody who has benefited from a distribution resulting from carried interest units, shares or rights) must make **a declaration to the tax authorities using IFU forms** submitted by February 15, 2010, at the latest:

- the identity and address of employees and directors who have benefited from net gains and distributions,

- the detail of the amount of these gains and distributions per beneficiary.

This remains the case, whatever the tax or social regime applicable to the carried interest units and shares and whenever the Fund was created or the shares were issued. By default these incur a taxation penalty of 50% of the total undeclared amounts.

AMF specifies rules applicable to contractual FCPRs

As well as the AMF General Regulations, which has had a section covering contractual FCPRs added (articles 414-33 et seq), the instruction dated April 4, 2009, relating to the simplified FCPR shareholder declaration and information procedure, was added to take account of this new category of Fund. On the whole, the shareholder declaration and information procedure has been based on the one for simplified FCPRs.

It should be noted however that the instruction stipulates that contractual FCPRs may be included in **pre-liquidation.** Yet the SMF does not specify anything in relation to this for contractual FCPRs. Furthermore, the appeal of pre-liquidation is to release funds from compliance with its investment ratio. But the contractual FCPR is not legally bound by any investment ratio…

The AMF instruction of November 3, 2009, relating to these Funds' prospectus, does confirm the AMF's position however. The standard contractual FCPR settlement model does stipulate that the settlement of the Fund should contain an article on pre-liquidation.

It should lastly be noted that in relation to the **Master and feeder funds,** the settlement model requires the declaration that "*the contractual FCPR is invested entirely in another contractual FCPR and incidentally in liquidities*". Should it therefore be deduced that the contractual FCPR cannot be a feeder for another Fund? We do not think so.

Money laundering: updating of parts III and V of the AMF General Regulations

The AMF General Regulations have been updated to incorporate the order published at the start of the year on money laundering. It now stipulates that "*the portfolio management company is subject to the terms of the present sub-section* [relating to the fight against money laundering] *in relation to investment services set out in article L. 321-1 of the CMF and the marketing, carried out by itself or by an agent, of the units or shares in the collective investment organization, whether it manages it or not.*" And must appoint "*a board member responsible for implementing the measures to fight money laundering and terrorist funding*".

In brief

Ruling of October 29, 2009, relating to the prudential regulation of payment institutions

This ruling modifies the approval and organization conditions for payment institutions.

Ruling of October 29, 2009, relating to the internal inspection of credit institutions and investment companies modifying regulation n° 97-02 of February 21, 1997

The text aims to reinforce internal control within credit institutions and investment companies (other than portfolio management companies).

Decree no. 2009-1431 dated November 20, 2009 relating to pension savings funds, modifying the French Social Security Code

It modifies some of the FRR's investment (profile ratio) and organization rules.

Take-up or extension of investments in financial companies

The rules applicable to take-up or extension of investments in the capital of a portfolio management company (ruling of November 6, 2009, approving modifications to the AMF General Regulations), a credit institution or an investment company (ruling of November 2, 2009, modifying regulation no. 96-16 of the Banking and Financial Regulation Committee) have been strengthened.

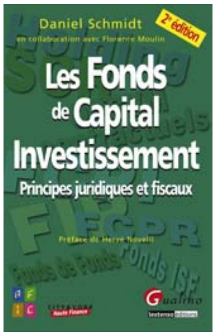
Fiscal instruction

4 A-15-09 n° 89 of October 21, 2009: Various provisions (Industrial and commercial profits, corporation tax, common provisions). Tax credits for industrial, commercial and agricultural businesses incurring R&D expenditure. Application procedures for provisions introduced by articles 27 and 101 of the 2009 Finance Act.

Upcoming conferences and latest publications

Events

- **December 8 - Breakfast with Capital Finance : Private Equity Funds: how to adapt the current environment ?** - Proskauer is co-sponsor of this conference - with Duff & Phelps, Global Private Equity and Capital Finance - In the offices of SwissLife Banque Privée - 8h30 - 10h00.
  With Caroline Chabrerie and Daniel Schmidt, partners at Proskauer
- **December 8 - Training EFE : Négociate & Master clauses in International Contracts** - With Delia Spitzer, Partner at Proskauer.
- **December 9 – Breakfast Debate LJA « Incapacity & Harrassment »** – Hôtel de Crillon - 9h00 - 11h30. With Béatrice Pola, Partner at Proskauer.
- **December 10 - Club RH** – In the offices of Proskauer in Paris - in partnership with AEF - 8h30 - 10h00. With Béatrice Pola, Partner at Proskauer.
- **December 18 - Lamy Conference : Discriminations, equal treatments : update and issues at stake in recent legislations** - Hôtel Regina - 8h-30 - 17h00. With Yasmine Tarasewicz, Partner at Proskauer.
- **January 14, 2010 – TEPA Capital Conference – at the Senate.** With Daniel Schmidt, Partner at Proskauer and Florence Moulin, Associate at Proskauer.



Publications:

- ***"Les Fonds de Capital Investissement, Principes Juridiques et Fiscaux"****,* *2nd edition,* Daniel Schmidt and Florence Moulin (Cabinet Proskauer Rose), Preface by Mr Hervé Novelli, Publisher Gualino. Currently on sale from the AFIC.

"Opinion Leaders" is also available on our website in the News and Publications section, under Newsletters: www.proskauer.com

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Corporate and Private Equity

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