

New regulatory framework for private equity in Spain

Draft Bill for the transposition of the Directive on Alternative Investment Fund Managers

On 18 July 2014 the Official Gazette published the Draft Bill regulating Private Equity and Venture Capital Funds (the "**Draft Bill**"). The Draft Bill constitutes a further landmark in the transposition of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers ("**AIFMD**").

Without prejudice to a more detailed analysis of the act when finally approved after the summer, the main new developments introduced by the Draft Bill are discussed below.

Key issues

- Abolition of the prior regime for the incorporation of externally managed private equity entities
- New entities and nomenclature
- Marketing, cross-border management and depositaries
- Other relevant new developments.

Abolition of the prior authorisation regime for the incorporation of externally managed private equity entities

The administrative intervention of the Spanish Securities Market Commission (*Comisión Nacional del Mercado de Valores* or CNMV) is removed almost entirely.

While prior authorisation is still required for the incorporation of fund managers (AIFMs) and internally or self-managed private equity entities, externally managed private equity entities (i.e. managed by an existing, authorised AIFM) may be set up immediately subject only to subsequent registration with the CNMV.

New entities and nomenclature

The Draft Bill introduces a handful of new entities.

1. Closed-ended collective investment undertakings

The Draft Bill introduces closed-ended collective investment undertakings (EICC), which may adopt the legal form of closed-ended collective investment companies (SICC) or closed-ended collective investment funds (FICC).

EICCs are collective investment undertakings without a commercial or industrial objective and which raise capital from investors by means of marketing activities, for subsequent investment in accordance with a defined investment policy.

Unlike private equity funds, EICCs are not subject to a specific investment regime as a matter of law, and may invest in all kinds of assets, including non-financial assets.

2. SME private equity entities

SME private equity entities (or ECR-Pymes) are introduced as a special kind of private equity entities that can adopt the legal form of an SME private equity companies (SCR-Pymes) or SME private equity funds (FCR-Pymes).

An ECR-Pyme must invest at least 70 per cent of its net assets in the following financial instruments that provide financing to small and medium-sized enterprises or "pymes": (a) shares and units in the capital or other securities or financial instruments that grant to right to subscribe or acquire capital; (b) participating loans; (c) hybrid financial instruments, provided that their profitability is linked to the company's profits

or losses and that the recovery of the principal in the event of insolvency of the borrower is not guaranteed; (d) secured or unsecured debt instruments granted to SMEs in which the ECR-Pyme already invests through one of the instruments described above, and (e) shares or units in other ECR-Pymes.

3. Closed-ended undertaking managers

Closed-ended undertaking managers (SGEIC) replace the former private equity undertaking managers (SGEGR) in all respects.

4. Simplified regime private equity undertakings

Finally, the Draft Bill derogates simplified regime private equity undertakings.

Marketing, cross-border management and depositaries

The Draft Bill introduces to the private equity sector a number of provisions traditionally associated with collective investment schemes and open-ended investment undertakings.

For the first time in Spain, shares and units of Spanish private equity undertakings may be marketed through advertisement to the following retail investors: (a) professional clients as defined in the Spanish Securities Market Act (*Ley del Mercado de Valores* or LMV); (b) investors who undertake to invest a minimum of EUR 100,000 and acknowledge in writing (in a document other than the investment commitment) that they are aware of the risks involved; (c) directors, managers or employees of private equity undertakings (where internally or self-managed) or of their respective managers; (d) any investors which invest in private equity undertakings whose securities are listed in a stock exchange and (e) investors who prove that they have experience in investment, management or advice of similar private equity undertakings.

Spanish managers with a "European passport" are also allowed to manage private equity undertakings established in other European Union Member States.

Finally, the Draft Bill imposes the obligation for SGEICs to designate a depositary for each private equity undertaking they manage, unless they are so-called "Small AIFs" (i.e. whose cumulative assets under management fall below a threshold of (i) EUR 100 million or (ii) EUR 500 million provided that they are unleveraged and do not grant investors redemption rights during a period of 5 years) which are marketed exclusively at professional investors.

Other relevant new developments

1. **Increased flexibility in respect of the mandatory investment ratios**

Private equity undertakings may include within their mandatory investment ratios an unlimited amount of participating loans provided that such loans are granted to companies that fall within the scope of their main investment activity and their profitability is completely linked to the profits and losses of the borrower (in such a way that it will be zero unless the borrower realises profits).

These participating loans completely linked to the results of the financed company are added to the existing possibility of including "regular" participating loans in the mandatory investment ratios up to 30 per cent of the net assets of the private equity undertaking.

2. **Calculation of net assets**

The Draft Bill clarifies the rules for calculating the net assets of private equity funds and companies, which are defined as the sum of the entity's equity, participating loans and deemed profits (net of tax), subject to such adjustments as the Ministry of Economy and Competitiveness or the CNMV see fit.

3. **Different classes of shares and units**

The Draft Bill includes a generic authorisation for the issue of different classes or types of shares and units, provided that any preferential treatment received by investors are clearly specified in the company by-laws or fund management regulations, as applicable.

The current rules are far stricter in that they only allow simplified regime private equity entities to issue one separate class (apart from the general class), to be subscribed only by promoters or founders of the fund.

4. **Contributions-in-kind to private equity funds**

The Draft Bill introduces the possibility to make contributions to private equity funds in assets eligible for investment, provided that the fund's management regulations envisage the applicable procedure and conditions, including valuation criteria.

The current rules only allow contributions-in-kind to private equity companies.

5. **Minimum capital for managers of closed-ended investment undertakings**

The Draft Bill establishes that SGEICs must have an initial, fully paid-up, share capital of EUR 125,000 euros. In addition, when the total value of the portfolios managed exceeds EUR 250 million, the SGEIC will have to increase its own resources by 0.02 per cent of the amount by which the value of the manager's portfolios exceeds EUR 250 million, up to a maximum of EUR 10 million.

By contrast, existing SGEICs must have a minimum initial capital of EUR 300,000, fully paid-up.

6. **Replacement of managers**

The Draft Bill states that investors of private equity undertakings may, in accordance with the applicable management regulations or by-laws, request to the CNMV the replacement or removal of the manager, subject only to presenting a substitute manager willing to take over the role.

References to the investors' redemption rights in case of replacement of managers have been also removed in the Draft Bill.

7. **Remuneration policy**

SGEICs must establish remuneration policies and procedures for their senior management, risk takers, control functions and any employees whose professional activities have a significant impact on the risk profile of the investment entities they manage, which are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the investments they manage.

8. ***Asset stripping***

When a private equity undertaking directly or indirectly acquires more than 50 per cent of the voting rights in an unlisted company, its manager will observe the following restrictions for a term of 24 months as of assuming control:

- (a) It will not adopt any capital reduction, with the exception of those reductions of share capital designed to (i) offset losses or (ii) increase the restricted reserves to a maximum of 10 per cent of the resulting capital.

(b) It will not distribute dividends if either of the following conditions is met:

1° When at closing of the last financial year, the amount of net assets is (or becomes as a result of the distribution) lower than the subscribed capital plus the legal and statutory restricted reserves.

2° When the distribution of dividends exceeds the amount of the results of the last closed financial year, plus the profits not distributed and expenses charged to freely available reserves, minus accumulated losses and provisioning charged to the legal and statutory restricted reserves.

(c) It will not acquire or redeem own shares or units by means of redemption to members when the acquisition places the amount of net assets below the threshold referred in point 1 of paragraph b) above.

These restrictions will not apply when the unlisted companies are small or medium-sized enterprises.

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