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Global Financial Services Insights

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Introduction

Welcome to the initial issue of Dentons' Financial Services report. Operating at the intersection of business, finance, policy and law, Dentons' global team offers unique authority on the new directions and developments driving financial markets worldwide.

In this report, lawyers and professionals from across Dentons' global platform channel their experience and share their insights on some of the most critical issues impacting global financial sectors and participants. Read on to learn about the major regulatory trends to keep an eye on in the coming year, and to gain new perspectives on hot topics such as crowdfunding and the JOBS Act. Find out how to take advantage of the burgeoning market for private equity in Central and Eastern Europe, as well as the opportunities for foreign direct investment in Poland. Examine a key ruling in the Czech Republic that may effect the application of "known creditors." From the shifting competition environment in China to the ins and outs of doing business in Canada, our team applies in-depth local and regional knowledge combined with expansive global awareness.

We hope this Financial Services report will shed light on some of the questions, issues and concerns at the forefront of your mind. Furthermore, we welcome your feedback on this report, as well as suggestions about the topics you'd like us to discuss in future issues and in other informational materials. Our goal is the same as yours: to help you succeed. We can best accomplish that with your input.

Thank you, and let us hear from you.

Seven global regulatory trends to watch in 2014

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Aggressive anti-cartel enforcement

Competition authorities around the world are vigorously pursuing domestic and international conspiracies and other anticompetitive activities.

Focus on the US

Criminal antitrust enforcement remains a top priority of the U.S. Department of Justice (DOJ) Antitrust Division. The US is targeting domestic and international cartels, prosecuting both corporations and individuals, whether foreign or domestic. The Antitrust Division is placing particular emphasis on combating international cartels. Through the end of Fiscal Year (FY) 2012, approximately 67 percent of conspiracy cases were associated with subjects or targets located in foreign countries. Of the approximate $7.8 billion in criminal antitrust fines imposed by the Division between FY 1997 and the end of FY 2012, approximately 97 percent were imposed in connection with the prosecution of international cartel activity. In addition, approximately 65 foreigners have served, or have been sentenced to serve, prison sentences in the US.

During FY 2013 the Antitrust Division filed 50 criminal cases and obtained $1.02 billion in criminal fines. The most notable example was the DOJ's ongoing investigation of cartel activity in the automotive parts industry. *On a single day in September*, nine Japanese manufacturers agreed to plead guilty to criminal price-fixing charges and were assessed more than $740 million in criminal fines.

The Antitrust Division's Corporate Leniency Program continues to be a particularly effective investigative tool for detecting large-scale international price-fixing cartels.

Within the cartel area, so-called "reverse payment" settlement cases will be an area to watch in 2014. In *Federal Trade Commission v. Actavis* (the Activis case), a "reverse payment" settlement occurred after a brand-name pharmaceutical manufacturer sued a generic manufacturer for patent infringement, with the generic firm allegedly accepting a payment

to stay out of the marketplace for a certain period of time. The court rejected the argument that, when the anticompetitive effects of reverse payments "fall within the scope of the exclusionary potential of the patent," they do not violate the antitrust laws. At the same time, the court rejected a "quick look" standard of presumptive illegality of such payments and concluded that a rule-or-reason standard applies and will take into account the size of the payment, its relation to expected litigation costs, its independence from other services for which it might represent payment, and the lack of any other convincing justification. The *Actavis* case is likely to lead to a period of intense rethinking of the extent to which it is possible to structure reverse payment settlements that will pass muster under the rule of reason.

Focus on the European Union

In 2013 the European Commission (the Commission) reached four new cartel decisions, imposing total fines of approximately EUR 1.9 billion, which made it an average year in the Commission's recent cartel enforcement history. The cases concerned covered sectors as diverse as financial markets, North Sea shrimp, and wire harnesses. The bulk of these fines were levied in cases involving financial institutions (in particular, fines totaling EUR1.043 billion were imposed in the Euro interest rate derivatives case, whereas the Yen interest rate derivatives case yielded fines of ca. EUR 669.7 million). This reflects the Commission's closer scrutiny of financial markets since the 2008 financial crisis.

EU scrutiny in the cartel area in 2014 is expected in the car parts sector (following the wire harness producers cartel decision of 2013) and in oil and biofuels, white sugar and cargo train transport services (following dawn raids conducted by the Commission in 2013).

More generally, the financial services sector can expect to enjoy the continued interest of the European Commission. There may be a resolution of pending cases such as a ruling by the European Court of Justice on the MasterCard appeal against a decision of the European Commission of 2007 that the member bank delegates of MasterCard had collectively set cross border fall back multilateral interchange fees. In addition, there may be progress this year on a regulation on interchange fees for card-based payment transactions which would impose a cap on the level of interchange fees charged in four-party payment (credit and debit) card schemes.

The Commission is also pushing forward with further cases involving agreements to delay market entry by generic drugs ("pay for delay" cases). For example, the Commission's June 2013 decision against Lundbeck is being appealed as the company challenges the Commission's contention that patent settlement agreements restrict competition by object, (i.e., there is no requirement to demonstrate that such agreements have an adverse impact on competition).

In addition to cartels, vertical competition restrictions are also very much within the Commission's sights. The three main areas to look out for in this regard in 2014 are: restrictions on online sales, resale price maintenance (RPM), and most favored nation clauses.

E-commerce is considered instrumental to achieving the goal of a single internal market in Europe and as a result, EU competition rules specifically target restrictions of online sales in distribution agreements. In the first major enforcement action in this area, in

December 2013, the Commission conducted dawn raids at companies active in the manufacture, distribution and retail of consumer electronics products and small domestic appliances, which it suspects of restricting online sales of their products. Resale price maintenance cases are also on the rise, both before the European Commission and before national competition authorities in the EU Member States. At the EU level, the General Court may rule in 2014 on the *Ordre national des pharmaciens* (ONP) appeal against the Commission's 2011 decision fining ONP for imposing minimum prices.

Finally, most favored nation (MFN) clauses have been the subject of attention in EU jurisprudence over the past two years. In 2013 MFN clauses were again prominent with the Commission accepting binding commitments in the e-books case from Penguin to refrain from including MFN clauses in agreements with retailers. In parallel, MFN cases flourished at the national level (notably in the UK and Germany) and are expected to be on the rise in 2014.

In this environment, it is critical for companies to have an effective antitrust compliance program. This includes focused training sessions with those senior executives who are responsible for major strategic planning, as well as those officers or employees whose conduct potentially carries the most antitrust risk to the company from charges of price fixing, market allocation or bid-rigging. Periodic reviews with key managers of their pricing and other business practices, sources of market information, and potential risk areas such as trade association activities and other competitor contacts will lower the risk of non-compliance.

Focus on China

Chinese government agencies are actively pursuing price-fixing and other anti-competitive behaviour.

The National Development and Reform Commission (NDRC) has used the anti-cartel law as a means of keeping prices, especially in key mass consumption sectors, under control. Major cartel cases in the past have involved rice noodles, garlic, beans, and infant milk formula industries. NDRC has announced that its anti-cartel efforts will continue to focus on products and services that are directly purchased by end consumers, such as food, groceries, drugs and internet products. In August 2013, international news outlets reported that NDRC had been working with the China Automobile Dealers Association to collect data on pricing behaviour of foreign auto manufacturers. It is believed that this data will be used by the NDRC to determine whether the automakers have required their distributors and retailers to resell products at a minimum price.

It is noteworthy that compared to fines imposed elsewhere, fines are much lower in China. For example, despite reaching all time highs in 2013, the total amount of fines was still much lower than fines imposed

by the European Commission.
In 2013, NDRC fined two liquor manufacturers and nine baby formula manufacturers for price fixing arrangements. The fines imposed on those companies ranged from 1% to 6% of sales revenue in the prior year.

The State Administration of Industry and Commerce (SAIC), which oversees non-price monopoly activities in China, announced in January 2014 that it would focus its efforts on regulating infrastructure industries such as telecom, public transportation, water, power and gas supply.

Close scrutiny of M&A under merger control rules

Antitrust authorities in major jurisdictions can be expected to continue their close scrutiny of M&A deals raising competition concerns, whether or not such deals are reportable. In addition, some jurisdictions are moving to streamline their merger control regimes.

Focus on the US

In the US, premerger filings under the Hart-Scott-Rodino (HSR) Act have recovered from recessionary levels—indeed, both FY 2012 and FY 2013 saw about twice as many filings as FY 2009. It is also notable that over a dozen consummated, non-reportable deals have been challenged during the Obama Administration.

The US agencies continue to pursue aggressive merger litigation strategy. In addition to various quantitative economic analyses, internal business documents prepared by the parties are increasingly relied upon by the agencies as evidence on key issues, such as relevant markets and potential anticompetitive effects. In this context, everyone involved in such deals (including investment bankers and other outside advisors) should be cautioned from the beginning to exercise care, to be measured, clear and precise in writing about the transaction and to avoid over-blown rhetoric or speculation about the potential impact on markets, prices or other competitive matters.

Mergers, joint ventures or other cooperative arrangements should be reviewed from an antitrust standpoint *early in the planning stages*, so that antitrust risks can be appropriately identified, and addressed or managed. In addition, the merging parties' coordination of filings and strategy on a worldwide basis is necessary given cooperation of authorities around the globe.

Focus on Canada

Canada's highest court will be addressing lower courts' application of the substantial prevention of competition test for requiring a merger remedy in *Tervita Corporation et. al. v. Commissioner of Competition* (Tervita). Tervita is notable as the Canadian Commissioner of Competition's first court challenge of a merger since 2005 and the first case involving a non-notifiable merger.

Focus on the European Union

On January 1, 2014, a package of measures to simplify the procedures for notifying mergers under the EU Merger Regulation came into effect. Specifically, the European Commission revised the simplified merger procedure notice to expand the categories of cases to which it will apply. It also reduced the amount of information that needs to be provided in merger notifications and published revised versions of its model texts for commitments and trustee mandates and accompanying Best Practice Guidelines.

Following a Commission consultation on a major revision of EU merger control rules in 2013, the Commission is, among other things, considering

modifying the mechanisms for pre- and post-notification referrals of merger cases from national competition authorities to the Commission. The most controversial proposal would extend the scope of the EU Merger Regulation to acquisitions of non-controlling minority shareholdings.

In this regard, the Commission has looked to the US, UK and Germany for examples of regimes which already subject non-controlling minority stake acquisitions to a merger control regime. In the most likely scenario, the Commission would propose a system under which it would have discretion to select cases to investigate. In other words, the notification of a non-controlling minority stake meeting certain thresholds would be mandatory, but not all cases would be pursued by the Commission.

One of the EU Member States which is also in the process of revising its merger control rules is Poland. The planned amendment to Polish competition law which is likely to be in force in 2014 foresees several measures aimed at relaxing the merger control procedure and making it more transparent, although it remains to be seen how it will be implemented.

The repercussions of the 2007-2008 financial crisis are still being felt in some merger control cases and in particular, the increase in the number of merger cases in which the failing firm defence is raised. For example, the Commission accepted a failing firm argument in the Olympic Air/ Aegean and Nynas/Harburg mergers in 2013. The postal sector is also facing upheavals on several fronts: legislative measures forcing its liberalization, the restructuring of the sector following changes in market trends, and the Commission's close scrutiny, including a decision in January 2013 to prohibit the UPS/ TNT Express merger (which decision has been appealed by the parties).

Focus on China

China's merger review authority, the Ministry of Commerce (MOFCOM), has continued to impose conditional approval on global mergers, including the mergers of Glencore-Xstrata, Marubeni-Gavilon, Baxter-Gambro and MediaTek-MStar. Notification of the recent merger of Thermo Fisher-LIFE was submitted in July 2013 and granted conditional approval on January 14, 2014. In the past 5 years since China's Anti-Monopoly Law came into effect, MOFCOM has granted conditional approvals in less than 3% of the total cases submitted and reviewed. However, there is a clear trend towards more conditional approvals based on the 11 conditional clearances in 2012 and 2013. In addition, the review period can be very long and can involve re-filing for cases with significant competition issues. For example, the MediaTek-MStar took 14 months to obtain final clearance. To date, this was the longest review period undertaken by MOFCOM. Multinational companies are advised to budget an appropriate amount of time for China's merger review when planning for their deals.

Despite this, MOFCOM has taken steps to streamline its review process for mergers that raise no competition issues. In 2013, MOFCOM released a draft regulation setting forth six different scenarios that qualify a case for a simplified review process. Three of the scenarios are based on market share criteria, two on the economic effect of the proposed transaction within China and one on the control between the parties of the proposed transaction. The draft regulation does not specify the procedures of the simplified review. It is expected that MOFCOM will issues new rules relating to the simplified review process.

Foreign investment and national security review in M&A

A significant regulatory trend to watch in 2014 is how governments treat foreign, and particularly state-owned, investors, as well as investments in strategic sectors.

Focus on Canada

Over the past year, the Canadian government has established new rules restricting and monitoring investments by foreign state-owned enterprises (SOEs) in Canada, indicating concerns about the prospects of foreign nationalization (following decades of privatization of Canadian state ownership in key sectors of the economy). The acquisition by Chinese SOE, CNOOC, of Canadian oil and gas company, Nexen, in early 2013 was approved by the government but triggered a public debate about the role of SOEs and ultimately resulted in a Canadian government policy that, going forward, prohibits SOEs from acquiring control of oil sands projects save in exceptional circumstances. The government also served notice that it would be monitoring SOE investments in other areas of the economy, and in particular would closely scrutinize SOE acquisitions in sectors where SOE investment was becoming significant. The new and tougher approach to SOEs was bolstered by amendments to the Investment Canada Act which broaden the definition of an SOE beyond foreign state ownership to include an entity "influenced" by a foreign government and expand the circumstances in which an SOE investment can be reviewed.

Apart from articulating a policy that could limit SOE investment in the Canadian economy, the government has demonstrated its willingness to block private foreign capital in key sectors such as telecommunications for national security reasons. The rejection of Egyptian-controlled Accelero Capital Holding's purchase of Allstream— the wireline enterprise services division of Manitoba Telecom Services Inc. (MTS) in October 2013 under the little-used and relatively new (2009) national security review law signalled the government's sensitivity to investments in critical and strategic areas of the economy such as telecommunications infrastructure.

Focus on US

Notifications and reviews of inbound foreign investment transactions by the Committee on Foreign Investment in the US (CFIUS) to determine whether they impair "national security" have dramatically increased in the last two years, and 2014 promises to be no different. In the most recent statistics reported by CFIUS (for 2012), 114 deals were reviewed by the Committee, with more than 40 percent of those deals being fully investigated by the Committee. CFIUS has the authority to review transactions involving a wide range of foreign investment into the United States, particularly those that involve foreign government investment (such as State-Owned Enterprises) and any investment in critical infrastructure. CFIUS is comprised of representatives from nine different departments and agencies within the Executive Branch of the U.S. government (including Commerce, Defence, Homeland Security and Justice) and is overseen by the US Treasury Department. "National security" is purposefully left

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undefined in the law creating CFIUS and in the implementing regulations published by CFIUS, so that "national security" can be interpreted in accordance with political exigencies.

While notifications to CFIUS of foreign investment transactions are not mandatory, once there is a required notification to one US government agency (i.e., an HSR filing) for a proposed transaction, a voluntary filing with the CFIUS agencies may well be advantageous. The benefit of notifying CFIUS of a proposed transaction is that, after CFIUS has cleared the transaction, the acquiring company has assurance that the transaction will not be investigated and possibly challenged after closing. A notification to CFIUS is essentially an insurance policy against post-closing U.S. regulatory review on "national security" grounds. The CFIUS process may require 30 days, or 75 days if CFIUS initiates a 45-day investigation (in addition to the initial 30 day review).

The CFIUS review process has again been the subject of high profile political and legal maneuvering. In 2012, for the first time in more than 20 years, the President blocked a proposed transaction — the construction and operation of a wind energy facility by a consortium of investors from China — on grounds of national security. Our experience over the past year suggests that the CFIUS agencies continue to apply a strict standard to investments in the energy sector, as well as those that involve proximity to US Defense installations, and presage an increase in the number of reviews that go through the full 75-day process and require mitigation measures before approvals are issued.

Focus on China

The Chinese central government has decided to simplify approval procedures and delegate approval authority for foreign investments. The principle is that unless there is a concern about national security, ecological security, production of material industries, development of strategic resources and material public interests, investments will be exempted from governmental approvals. In the past year, the Chinese government has increasingly relaxed its control over foreign investments. In addition, capital controls are likely to be further eased in the future.

A key development regarding foreign investment is the unveiling of China's first free trade zone, which opened in Shanghai in October 2013. The plan, which will take three years to fully implement, is the latest step in China's national strategy to further open up markets and promote Shanghai as an international trade and financial hub. China released a negative list of the restricted and prohibited sectors for foreign investment, which covers 18 sectors ranging from agriculture to manufacturing to finance to public services. For sectors beyond the negative list, foreign enterprises registered in the free trade zone may invest as freely as their domestic peers. The negative list will be updated every year and will be shortened as negotiation of bilateral investment treaties with the U.S. and European Union make progress.

China has also announced that it will be amending its three major laws to relax the rules on foreign-investment enterprises. In addition, China's State Administration of Foreign Exchange (SAFE) has simplified the process of settling international service-related payments. The new rules apply to service-related payments, such as service fees, advances and expense reimbursements, with a general principle of looser regulatory restrictions on service-related payments that are based upon genuine and lawful transactions. SAFE's statistics show that the new rules apply to around 80% of the service related payment and has enhanced the efficiency of a substantial amount of foreign exchange payments in the service sector.

Heightened anticorruption enforcement

The increasing focus on enforcement of the US Foreign Corrupt Practices Act (FCPA), Canadian Corruption of Foreign Public Officials Act, and UK Bribery Act, as well as similar anti-corruption laws around the globe, has made anti-corruption compliance more essential than ever.

Whether in the European Union, the United States or Canada, the pace of privacy and data protection reform and enforcement action is expected to accelerate.

In particular, conducting pre-acquisition anti-corruption due diligence is a critical element of any cross-border merger or acquisition. The failure to conduct pre-acquisition anti-corruption due diligence can result in severe legal and financial consequences, as well as reputational damage, for both buyers and sellers. For buyers, anti-corruption diligence can be especially critical because, under US principles of successor liability, a buyer may be held liable for pre-closing FCPA violations by the target. And if illegal conduct by the acquired company continues post-closing, the buyer can be held directly liable, even if it had no knowledge of or participation in the violation.

For sellers, apart from individual liability (which would survive a transfer of ownership or control), concerns about potential pre-closing violations can strongly influence a deal's value, if not threaten the entire transaction. Moreover, sellers may be asked to provide specific representations — or even fundamental representations — and warranties as to anti-corruption compliance that are backed by broad indemnification provisions and hefty escrow amounts.

The two US government agencies responsible for enforcing the FCPA, the US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC), have endorsed a risk-based approach to conducting pre-acquisition anti-corruption due diligence. Such an approach requires an initial evaluation of the target's risk profile, followed by the creation and subsequent implementation of a work plan that incorporates review procedures specifically tailored to and commensurate with the risks identified. Even if pre-acquisition anti-corruption diligence does not reveal evidence of bribery, conducting such a review can help to identify "red flag" indicators of corruption and potential control weaknesses. The prospective buyer can then address the issues with the seller (including through remediation) and the results of the review can be factored into the deal terms and pricing. If you do not devote sufficient time and resources to try to detect corrupt practices pre-closing, arguments that you were an "innocent purchaser" may fall on deaf ears.

Focus on China

The Chinese government is vigorously pursuing endemic and widespread corruption. In 2013, this trend was especially evident in the healthcare industry. In June 2013, a Chinese subsidiary of GlaxoSmithKline (GSK) was accused of paying almost $500 million in bribes to Chinese doctors and hospitals in exchange for purchasing or prescribing GSK's products. In response, China has issued a series of new measures. The National Health and Family Planning Commission (NHFPC) and its provincial branches will maintain and publish on their websites a blacklist of medical manufacturers and distributors with a history of bribing hospitals or health care professionals. Such companies will be prohibited from participating in or will be downgraded in public hospitals' procurement of medicine and medical devices. NHFPC also issued new rules reiterating the prohibition on hospitals and healthcare professionals from receiving kickbacks and other forms of bribery. In particular, hospitals and healthcare professionals are not permitted to receive improper sponsorship and donations from outside parties. Sponsorships and donations must not be conditional upon any terms that will "impact fair competition" or be related to the procurement of products or service. In 2014, the medical industry will

continue to be closely monitored by the Chinese government. Given rampant commercial bribery in China's medical system, medical companies will face serious challenges in the future as they balance the realities of business and the crackdown by authorities.

Apart from the healthcare sector, multiple anti-corruption measures have been passed by government agencies at the central and local levels in 2013. These regulations ban the use of luxury cars, eliminate lavish gifts for government officials, and place limits on galas, official dinners, and special privileges that party cadres have long enjoyed. The Chinese government also launched a series of high profile enforcement actions against senior-ranking government officials at both the central government and local levels. As an example, the former Railways Minister Liu Zhijun was convicted of accepting bribes and given a suspended death sentence.

Accelerated privacy and data protection reform and enforcement

Whether in the European Union, the United States or Canada, the pace of privacy and data protection reform and enforcement action is expected to accelerate, particularly during the second half of the year.

Focus on Europe

The proposal to adopt a Data Protection Regulation (DPR) to replace the current Data Protection Directive and patchwork of national laws will continue to be studied and negotiated. Currently, the draft DPR would provide data protection authorities (DPAs) with the power to levy fines of 2% to 5% of annual worldwide turnover for breaches, expand the scope to govern third party processors outside of the EU who process EU data, and establish a lead authority framework in which an organization would be subject to a primary national data protection authority. Although it is unlikely that the DPR will be finalized in 2014, it is expected that the pace of negotiations will increase following the May 2014 EU Parliamentary elections.

Focus on the US

California's Do-Not-Track legislation is in force requiring companies to indicate in their privacy policies how they respond to Do Not Track signals from web browsers. In addition, the new Children's Online Privacy Protection Act Rules provide new guidelines for obtaining verifiable parental consent to the collection of personal information. Organizations may see significant enforcement action with respect to both of these developments in 2014.

Beyond enforcement, it is expected that there may be a continued push to address national and international concerns regarding oversight of the collection and use of personal information by US intelligence. The appointment of a Chief Privacy Officer for the National Security Agency

is one step in that direction, but it is unlikely to satisfy the EU, which continues to negotiate a framework agreement with the US that, if the EU is successful, could include redress provisions for EU citizens.

Focus on Canada

The Supreme Court of Canada struck down the Alberta Personal Information Protection Act late in 2013 but stayed its own decision to give the Alberta Legislature twelve months to revise it. The issue in the Alberta case was a conflict between privacy rights and freedom of expression for unions engaged in a strike. The union had collected photos of individuals crossing a picket line. The British Columbia Personal Information Protection Act is structured the same way as the Alberta legislation and so the decision has implications for that province as well. Legislative revisions may be proposed later this year to recalibrate the balance between data privacy and freedom of expression.

Federally, a new Privacy Commissioner is expected to be appointed. In addition, the Office of the Privacy Commissioner is expected to continue to explore opportunities for joint enforcement action with other oversight bodies, following its joint investigation of WhatsApp, Inc. in 2013 with the Dutch DPA. And, with the Federal Court recently awarding an individual damages of CAD $20,000 (inclusive of $10,000 in exemplary damages) in a case where Bell TV was found to have failed to obtain valid consent for a credit bureau check, we expect to see the pace of individual actions for damages from privacy breaches to increase.

Focus on IP issues by antitrust/competition agencies

Competition authorities in key jurisdictions will continue to focus attention on antitrust issues arising from the exercise of intellectual property rights.

Patent Hold-up

Focus on the US

In the US, agency interest in "patent hold-up" is keen in relation to the determination of royalties on patents (standard-essential patents or SEPs) tied to standards developed by standard-setting organizations (SSOs). In particular, there is concern that a firm with an SEP can demand royalty payments, and other favorable licensing terms, based not only on the market value of the patented invention before it was included in the standard, but also on the costs and delays of switching away from the standardized technology.

Standard-setting organizations (SSOs) commonly seek to mitigate the threat of patent hold-up by seeking commitments from participants to license SEPs on "fair, reasonable, and non-discriminatory" (FRAND) terms, often as a quid pro quo for the inclusion of the patent(s) in the standard. But the potential for hold-up remains if the FRAND commitment is later disregarded, because the royalty rate often is negotiated after the standard is adopted.

In January 2013, the Antitrust Division and the U.S. Patent & Trademark Office (PTO) issued a policy statement recommending that the U.S. International Trade Commission (ITC), when considering whether an order excluding non-licensed patented products from the U.S. is in the "public interest," should take

into account whether the infringer is acting within the scope of the patent holder's FRAND commitment and is able, and has not refused, to license the patent on FRAND terms.

Focus on the European Union

The European Commission is likely to make progress in 2014 in cases relating to the alleged misuse of mobile phone standard essential patents. Joaquin Almunia, the Commissioner responsible for competition, has in the past spoken of the Commission's intention to prevent the abusive use of necessary patents from hindering competition in new, innovative technology markets. As a result, further cases in this area are anticipated.

Patent assertion entity (PAE) activity

Focus on the US

PAEs are a type of nonpractising entity (NPE) that owns patents but does not practise them. PAEs acquire patents from existing owners and make money by licensing them to—and litigating against—manufacturers that use the patents. PAEs are playing a larger role in patent litigation. While supporters claim that PAEs are efficient middlemen that increase the return to invention, especially for small inventors, critics argue that PAEs exploit flaws in the patent system and add to a growing tax on innovation.

In 2012 the FTC and Antitrust Division held a workshop to explore the impact of PAE activities on innovation and competition and the implications for antitrust enforcement and policy. More recently, the FTC is aiming to use its statutory authority to collect nonpublic information for the purpose of conducting industry studies to expand the empirical evidence on PAE activity, including examining the PAE business model generally as well as PAE activity in the wireless sector. The FTC hopes to develop a fuller and more accurate picture of PAE activity, which it can then share with Congress, other government agencies, academics, and industry.

Focus on China

In 2013, the State Administration of Industry and Commerce (SAIC), the authority that regulates market activities in violation of the Anti-Monopoly Law (AML), formulated guidelines and rules relating to the prevention of abuse of IP rights to eliminate or restrict competition. While the AML prohibits such abuse, it does not specify what activities are considered abusive. SAIC is developing guidelines and rules that aim to define abusive conduct and the concept of the "relevant market" as well as safe harbours for certain justifiable activities. SAIC announced in 2013 that it will issue a fifth draft of the guidelines and rules, but it is uncertain when they will be formally released.

Private enforcement of antitrust/competition law

Class actions based on antitrust/competition claims face new challenges in some jurisdictions and are bolstered in others.

Focus on the US

The US Supreme Court addressed standards for class certification in private antitrust actions, underlining the difficulty of demonstrating damages on a class-wide basis in some circumstances. In *Comcast Corp. v. Behrend*, the Supreme Court held that plaintiffs failed to demonstrate at the class certification stage that damages could be established on a class-wide basis at trial. Absent a method for establishing

damages on a class-wide basis, "[q]uestions of individual damage calculations will inevitably overwhelm questions common to the class." The Supreme Court found that the class was improperly certified because the finding that common questions predominated rested on a damages model that did not fit the substantive legal theories remaining in the case. The inability of the damages model "to bridge the differences between supra-competitive prices in general and supra-competitive prices attributable to the deterrence of overbuilding" precluded a finding that common questions predominated.

Focus on Canada

The Supreme Court of Canada held in a trilogy of cases in 2013 that indirect purchasers are able to sue for damages in class actions for contraventions of the conspiracy provisions of the Competition Act. While plaintiffs will still have to address the evidentiary burden of proving their damage claims, this decision could embolden plaintiffs and their counsel to pursue more competition class actions in the coming year.

Focus on the EU

Under EU law, any person who has suffered harm caused by an antitrust infringement can claim compensation based on national law. Most cases are brought in very few Member States - primarily the United Kingdom, Germany, and the Netherlands.

In June 2013, the European Commission adopted a series of documents aimed at facilitating the development of private antitrust enforcement in the EU Member States, including: a proposal for a directive on certain rules governing actions for damages under national law for infringements of national and EU competition law; a Commission communication on quantifying harm in actions for damages; a communication regarding a series of common, non-binding principles for collective redress mechanisms in Member States; and a recommendation that Member States establish collective redress mechanisms for breaches of EU law (including competition law) within two years. On January 27, 2014, the European Parliament voted on changes to the draft directive and agreed to enter into three-way talks with EU governments and the European Commission (which may start as early as February 2014) to work out the final version of the legislation. This means the bill may be passed by May 2014.

The Parliament rejected a proposal to incorporate in the draft Directive a reference which would prompt EU governments to encourage class litigation in the antitrust area, out of fear it would open the door to US-style litigation. There was no clear consensus on other sensitive issues, which are now bound to lead to heavy discussions during tripartite negotiations. This includes the question of disclosure of evidence from the cartel investigation, protecting leniency applicants from larger damages payouts, and how indirect purchasers are treated.

A major issue that has emerged in the EU is the extent to which potential plaintiffs in antitrust damages actions should have access to documents gathered by the Commission (or national competition authorities) in the course of antitrust investigations. Access to such information highlights a tension between the Commission's drive to develop private antitrust enforcement and the concern that public antitrust enforcement could be jeopardized. This tension may be addressed in 2014 through cases such as: Netherlands v Commission; Commission v EnBW Energie Baden-Wurttemberg; Henkel v Commission; and Pilkington Group v Commission.

Focus on China

On August 2, 2013, the Shanghai High Court released the final decision on Beijing Ruibang Yonghe Technology & Trade Co v. Johnson & Johnson Medical (Shanghai) Ltd. and Johnson & Johnson Medical (China) Ltd., the first civil action on vertical monopoly agreement in China. The court's

decision provides a framework for several previously unclear legal issues in the AML, including the establishment of the "rule of reason" principle in deciding the legality of a vertical monopoly agreement, the key factors in deciding the impact of the restraint on trade and the economy, and the standard for calculating damages caused by such agreement.

As vertical arrangements such as resale price maintenance between manufacturers and distributors are not uncommon in China, this case may serve as a precedent for more civil actions brought by distributors against manufacturers/licensors. We also note that both the plaintiff and defendant in this case presented data on sales and change of prices of the product, market analysis conducted by professional market research firms and expert witnesses. This case may represent the beginning of a new level of complexity in AML cases.

Companies that engage in vertical price maintenance agreements are advised to seek legal counsel to review local distribution contracts, business policies and internal rules to better understand and make informed decisions regarding potential civil liability.

If you have any questions regarding the above, please do not hesitate to contact one of the contributors.

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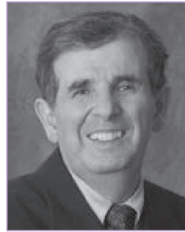

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Guide to foreign direct investment in Poland

By: Arkadiusz Krasnodebski, Pirouzan Parvine, Michał Bernat, Piotr Dulewicz, Cezary Przygodzki and Krzysztof Sajewski

Poland is the only country in the European Union which did not experience recession during the global economic crisis and which has had the highest economic growth in the region in recent years. Poland's stability and safety are guaranteed by NATO and EU memberships, thus making it a reliable and important business partner for foreign investors.

This opinion is confirmed by international publications. According to the "Bloomberg 2013" rating, Poland is the best country in Middle and Eastern Europe in which to do business. In the "FDI Intelligence and European Attractiveness Survey 2012" prepared by EY, Poland was ranked third after China and the US as the best place for manufacturing investments in the world and second as the most attractive country in Europe in which to invest in the coming years.

This position is due to a unique combination of a stable economic and political situation, a qualified work force, an internal market of almost 40

Quick facts

Area	Population	Capital	Major cities	Currency	Life expectancy	Time	Membership
312 679 km^2	38 533 299 (Central Statistical Office as of 31.12.2012)	Warsaw	Gdansk Lodz Krakow Poznan Wroclaw	Złoty (PLN) = 100 groszy (gr.)	females 81.0, males 72.7	GMT +1	EU, EEA, NATO, OECD, WTO

Source: FDI inflow: National Bank of Poland, other data: Central Statistical Office

Key economic numbers

Category	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
GDP (PLN billion)	843	925	983	1 060	1 177	1 275	1 344	1 415	1 528	1 595
Real GDP growth (%)	3.9	5.3	3.6	6.2	6.8	5.1	1.8	3.9	4.5	2.0
FDI inflow (€ billion)	4.06	10.23	8.33	15.74	17.24	10.12	9.34	10.47	13.56	2.65
Unemployment rate (%)	20.0	19.0	17.6	14.8	11.2	9.5	12.1	12.3	12.5	13.4
Exports (€ billion)	47.52	59.69	71.42	87.92	101.83	116.24	98.21	120.37	136.69	141.94
Imports (€ billion)	60.35	71.35	81.17	100.78	120.39	142.44	107.52	134.18	152.56	151.68

million citizens, as well as its strategic location providing access to Western and Eastern European markets and the inflow of EU structural funds.

Legal framework for establishing a business presence in Poland

Major rules:

- Since Poland is a member of the European Union, a company established in Poland may pursue activities in other EU member states on an equal footing. As a result, establishing a company in Poland opens the door for investors throughout the EU.
- The main vehicles used by foreign investors are limited liability companies (LLC) and joint-stock companies (JSC). Other vehicles, such as partnerships or branches, while sometimes utilized (mostly for tax reasons), are rarer and may not be accessible for investors from outside the EEA/EU area.
- Out of the two, the LLC, being roughly the equivalent of a private limited company (in the UK) or a GmbH (in Germany) is more popular. A JSC (the equivalent of a public limited company in the UK or an Aktiengesellschaft in Germany) is typically chosen when required by law for select types of business (such as banks, insurance companies), or if the investor intends to list the company (LLC shares cannot be publicly traded).
- The advantages of an LLC as a business vehicle include: (a) the exclusion of shareholders' liability (piercing the corporate veil doctrine generally does not apply in Poland); (b) relatively few corporate formalities which reduces operating costs; (c) a high degree of flexibility: LLC statutes may be adapted to its shareholders' needs; (d) the ability to conduct almost every kind of business (except, in particular, banking and insurance activities).
- The Polish regulatory regime is quite liberal; as a rule, no administrative consent is required to establish a company and run a business, unless the law states otherwise. Most manufacturing and non-financial services companies do not need a general permit to operate.
- In most types of businesses, members of their corporate authorities may come from any country, and no specific authorization is required to appoint them.
- In brownfield projects, the acquisition of a going concern can generally take the form of either: (a) the acquisition of shares in the company running the business; or (b) the acquisition of an enterprise, its organized part, or selected assets.
- Liquidating a company in Poland is typically a straightforward albeit time-consuming process. For companies which have dispose of their business (in the course of divestment), their liquidation may take approximately 7-8 months.

Corporate laws in Poland provide for a range of flexible structures and vehicles to establish a local presence, arrange relationships with partners, obtain financing and restructure activities.

Tips:

- A business presence can be established in one of two ways: (a) by creating a new company; or (b) by purchasing a shelf company. Creating a new company is typically slightly more cost-efficient (the related costs should be in the range of PLN 10,000, excluding payment for share capital), however it is usually quite time-consuming; it could take even up to two months to get it fully operational (although this process may be accelerated, e.g., by establishing the company via the Internet; however, for a variety of reasons, that might not be appropriate for every transaction).
- The acquisition of a shelf company can be effected almost in an instant (one to two days before the company is able to conduct business); however the process tends to be more costly due to the remuneration of the shelf company provider. Overall, the costs typically do not exceed PLN 15,000 (excluding reimbursement for share capital, which in the case of a typical shelf company would be the statutory minimum of PLN 5,000).
- In brownfield investments, adjust your transaction approach to the envisaged acquisition structure. Note the legal peculiarities that will apply to each of the structures, and specifically:
  - make sure the due diligence covers sensitive areas relevant to the given transaction structure (e.g. the title to the shares in a share deal, the transferability of permits and agreements in an asset deal);
  - adjust the timing (e.g. in an asset deal, obtaining third party consents to the transfer of key agreements may prove time-consuming);
  - ensure that the transaction documentation properly addresses any peculiarities (e.g., put emphasis on properly drafted representations and warranties, specifically if the acquisition is structured as a share deal).
  - Check if the given business requires a license to operate, and if it does, what are the particular requirements that the investor needs to fulfil in order to apply for it. Note that such requirements might not apply, e.g. if the acquisition is structured as a share deal.

Red flags:

- From the brownfield investment perspective, it is important to note that many acquisitions in Poland are made either from the state (typically in the form of privatization) or from local individual entrepreneurs. Each type of acquisition has its own peculiarities, and specifically, managers or officials responsible for the given privatization as well as the individual businessmen, may not be familiar with the large-scale international business environment (in fact, they seldom are), which may result in a protracted acquisition process and additional costs for the investor (both at the stage of due diligence, as well as negotiations).
- Further, privatizations are regulated, and the scope for negotiation is limited. In acquisitions of state enterprises, certain conditions (which may sometimes be arduous) are imposed. In particular, this applies to employees' participation in the company's governing bodies; the obligation to maintain the current level of employment in the acquired enterprise; or the prohibition of reselling the shares and assets within a specified period.
- With regard to brownfield investments structured as share acquisitions, it should be noted that the Polish statutory warranty regime can be vague and ambiguous (it is not clear to what extent it will apply to the assets in the possession of the company in which the shares

are traded), which can at times jeopardise the interests of the purchaser. As a result it is essential for the investor to ensure that the contractual representations and warranties regarding the company are properly drafted.

- As noted above, while the overall regulatory regime tends to be liberal, certain types of businesses are licensed. In particular, this relates to banking, insurance, energy and the media. Obtaining a license is often time-consuming and requires the fulfilment of specific conditions (which may relate to the investor's identity, the company's financial conditions or the company's technical equipment).
- Members of an LLC or JSC management board may be held civilly and criminally liable in specific cases (in particular, if they fail to file for bankruptcy when their company's condition requires this by law, or if they do not file the appropriate documents with the Registry Court). A management board member's liability cannot be limited or excluded. However, different instruments to minimize the financial liability of managers are in common use.
- Withdrawal of capital from a company is restricted and subject to formalized time-consuming procedures. In principle, a contribution made by a shareholder is non-refundable during the term of the company's existence. However, in practice there are some legal instruments enabling the return of capital notwithstanding the legal restrictions.
- Exiting an investment by liquidation is formalized and time consuming even if the company has neither financial resources nor assets. The assets of a liquidated company may be distributed among the shareholders only after satisfying or securing the creditors and not earlier than 6 months (for an LLC) or one year (for a JSC) following the date of summoning the company's creditors to state their claims. In consequence, the immediate return of capital invested in a company is not possible.
- Even though most services businesses do not require any permits, certain sectors related to financial services, media services and the energy sector tend to be more regulated (regulations may pertain to obtaining official authorizations, to choosing particular types of corporate vehicles by which the given business must be run, to requirements concerning the credentials of persons appointed to the management board, etc.). Investors intending to operate in restricted sectors should take note of the applicable regulatory provisions.

Public support for Foreign Direct Investment – key incentives

Special Economic Zones (SEZ):

- There are 14 special economic zones situated near major industrial, academic and transportation hubs and in outlying regions offering qualified workforces and optimization of costs. The activity of Special Economic Zones has been extended until 2026. Previously, the SEZ regime was set to expire at the end of 2020.
- A SEZ permit currently provides a corporate income tax exemption of up to 30%, 40% or 50% of the eligible investment costs (capital expenditure or 2 years' payroll); medium or small businesses may qualify for 60% or 70% thresholds respectively. Please note, however,

that those aid intensities are set to decrease in 2014.

- A SEZ exemption may be accumulated with other regional investment aids.
- The acquisition of shares in a company with a SEZ permit principally allows the investor to enjoy the benefits of the SEZ exemption.
- Subsidized business must be conducted in the SEZ and assets should be held and the stipulated level of employment retained in the SEZ for at least 5 years (in respect of large investors) following completion of the investment.

EU funds:

- EU funds proved to be one of the most attractive sources of aid to investment in 2007-2013; moreover, the EU has confirmed its allocation of extensive funds to Poland for 2014-2020.
- EU funding has been available for a variety of projects and sectors, from manufacturing to service centres, from traditional production lines to research and innovation, from energy, transport and industrial infrastructure to health care, education, financial industry and services.
- As a matter of principle, EU funding has been offered to investors through competitive tenders, in which various bidders submit their projects during the application periods set by the authorities.

Other key incentives:

- Real estate tax exemptions: provided by local authorities based on capital expenditure or employment targets; these benefits do not require any individual permit from the authorities and often provide significant cash relief for investors wishing to own the title to real property and infrastructure rather than lease such assets.
- Innovation tax credit: the investor is allowed, by law, to deduct from the taxable base 50% of the cost of acquisition of new technologies, and, in parallel, enjoy the tax depreciation rates available for such technologies under the general rules.
- Long-term government subsidies: based on an individual decision of the government and an agreement with the Ministry of Economy, a cash grant may be provided for investments in specific sectors.
- Employment subsidies: tangible cash support typically offered by local unemployment offices to investors creating new workplaces.
- Non-cash support: depending on the area and sector, local authorities may also provide, in addition to cash instruments or, when they have insufficient funds, various in-kind benefits such as pre-development of land, improvement of local infrastructure and services, recruitment support, public procurement contracts or exclusivity.
- Restructuring aid: relevant when targeting ailing firms.

Tips:

- Immense support will be made available to Poland from 2014 through 2020. Based on experience, the principal funds are allocated on a first come, first served basis. Consequently, the major funding opportunities will crop up earlier rather than later, so investors are strongly encouraged to review their investment plans as soon as possible and not to delay entry into the Polish market.
- Although subsidy agreements tend to be based on templates pre-established by the authorities, it is extremely useful to consider

A range of investment incentives is customarily offered to foreign investors and EU funds look set to remain generous for years to come.

and negotiate, whenever possible, change of control clauses or potential downsizing conditions; these would give the investor greater flexibility in subsequent operations and restructuring, and help avoid litigation and recovery of aid if the investment does not meet expectations.

- In addition, to avoid change-of-control restrictions, exits through alternative structures (including share deals) may be considered.
- The total threshold of aid available to FDI is usually above the amount of aid offered under any specific instrument; therefore, it is strongly suggested to combine various aid measures so as to effectively make use of the entire state aid limit or to reach that limit much sooner than would be the case for a single incentive.
- Management and timing are essential when applying for aid, particularly when investors intend to develop a state aid package; to streamline the process, a number of steps may be applied in practice, including start-up presentations to the key agencies and signing letters of intent with all the authorities and parties involved.

Red flags:

- Investment incentives are available provided that aid is applied for before the actual investment decision is made and its implementation begins; hence, it is crucial to consider and apply for aid well in advance. It is possible for an investor to seek initial advice on the contemplated project, but contracts with local suppliers or construction works commenced before an aid application is filed would usually render the expenses in question or even the entire investment ineligible for public aid (please note that in certain areas, the rules on timing investment procedures may be even stricter).
- Only new assets may qualify as eligible for large investments, and intangibles are eligible for aid only up to 50% of their value.
- Subsidized investment projects may involve individual notifications to the European Commission.
- Large investors would typically be required to retain their investments (without any substantial modifications) for five years following their completion and, consequently, the disposal of subsidized assets or of a branch of business, or even adjustments in the business model may be subject to restrictions during that period.
- Irrespective of investment commitments, in EU-funded projects, investors should also comply with other EU policies, such as state aid law, public procurement, environmental protection and their like; any infringement in those areas could have a detrimental effect on funding.
- Tax exemptions available in SEZs apply solely to those activities which are carried out within the SEZ and are covered by the SEZ permit; hence, outsourcing/allocating a part of one's operating or manufacturing activities to entities operating outside the SEZ may proportionally reduce the effective SEZ tax exemption.
- Depending on the aid measures considered, certain sectors are not eligible for SEZ-related benefits and reliefs (e.g. construction and development, wholesale, retail and financial services).
- The recent case record suggests that despite the regular supervision of the Polish authorities, the European Commission may from time to time challenge the allocation of EU funds to specific investors or programmes. When that happens, the Polish authorities could refuse to disburse the funding that has

already been granted or seek to recover aid previously distributed. Even though various legal actions could be envisaged to mitigate the risk of such recovery, it is also useful to first carefully negotiate any recovery clause in the subsidy agreement, and to keep a watching brief on the behaviour of the aid-granting authorities against the background of EU funding and state aid laws.

- As a rule, public aid can cover only a part of the investment costs and the investor is required to finance the balance of the investment expenditure; the intensity of public aid may also vary depending on the aid measure in question and the project.

Tax compliance and efficiency

Major rules:

- An existing business may be acquired through a share deal, the acquisition of going concern or the purchase of separate assets; each of those scenarios have considerably different tax effects and deserve careful consideration.
- Decide beforehand on the profit distribution pattern; depending on your sector of activity, you may find one of the following methods best suited to repatriating your profits: dividend distributions, interest payments, royalties or services fees.
- Register for tax purposes and apply for any relevant tax rulings well in advance of the actual commencement of the investment; tax rulings are issued within 3 months, which may delay the investment process.
- If you intend to acquire real property, examine its previous record as it may have a crucial impact on the VAT aspects, cash flow and timing of the transaction.
- As you contemplate financing your Polish investment, you should consider vital tax aspects such as withholding taxes, deductibility of interest, thin capitalization, stamp duty and foreign exchange effects; if carefully managed, intra-group financing may be arranged for your Polish investment and operations at little or no tax cost.
- Reflect a fair and accurate allocation of tasks, duties, functions and costs within your capital group: this could significantly mitigate the local tax exposure of your Polish operations.
- If possible, consider investment in one of the many Special Economic Zones to obtain a corporate income tax exemption of up to 50% (for large investors), as well as other tax benefits.

Tips:

- A number of established, legitimate investment schemes may be used to maximize returns on investments such as: share exchanges, tax consolidations, closed-end investment funds, step-ups on acquired assets, profit-participating loans and plenty of others, tailored to your business aims.
- In recent tax practice, executive staff and managers have been able to enjoy particularly beneficial tax arrangements combined with efficiency incentives.
- Corporate restructuring may often be effected at little or no tax cost.
- If properly placed in your corporate structure, a Polish subsidiary may incur little or no withholding tax.

Tax rules are generally lenient and the tax rates attractive. Various legitimate measures are available to investors to mitigate any excessive tax burden which so often hinders profitability and growth potential in other jurisdictions.

- In heavily capitalized subsidiaries, excessive stamp duty can be avoided by allocating a large proportion of your contribution to a share premium.
- A number of measures, such as the voluntary redemption of shares, may be applied to distribute profits tax-free.

Red flags:

- If you acquire Polish assets subject to VAT, make sure that the VAT is duly charged and could be recovered; if necessary, apply for a tax ruling in that respect. Note that if a seller charges an incorrect amount of VAT, the tax office will normally refuse to refund the corresponding amount of input VAT to the acquirer.
- Unless properly structured, the acquisition of local assets as a going concern may involve the assumption of liability for the tax debt of the seller; to preclude that risk, review the structure of the transaction and obtain comfort through tax certificates, if necessary.
- Some of the traditional investment schemes (including e.g. Luxembourg vehicles) have been significantly affected by recent changes in the Polish tax treaties and domestic laws; their adjustment may be advisable.
- Avoid investment in Polish subsidiaries through foreign partnerships if you intend to distribute profits as dividends and be careful with intragroup loans to Polish partnerships.
- The deduction of interest on debt assumed from the seller of the local assets may be challenged by the tax authorities.

Exemptions and beneficial tax regimes:

- No withholding tax on dividends distributed to EEA/EU shareholders holding at least 10% in a Polish subsidiary for at least 2 years
- 0% withholding tax on interest and royalties distributed to EEA/EU shareholders holding at least 25% in a Polish subsidiary for at least 2 years
- Exemption from corporate income tax on mergers and spin-offs
- Exchange of shares exempt from tax, subject to conditions
- Leasing of business assets
- Corporate income tax exemptions for foreign and domestic investment funds
- Real estate tax exemptions on local investments
- Foreign and shareholder loans free from stamp duty
- VAT exemptions for used real premises

Start-up and M&A rules:

- Corporations may choose tax years compatible with their business models.
- Tax losses incurred during the investment stage can be carried forward into the 5 subsequent years (up to 50% a year).
- Tax losses incurred by a company acquired through a merger cannot be carried forward.
- Interest received by a Polish subsidiary on intra-group debt in excess of the thin capitalization thresholds is not tax-deductible.
- The acquisition of a going concern may necessitate the return of a part of the input VAT paid and deducted by the seller.

- Prior to the acquisition of a going concern, tax certificates should be sought from the tax authorities confirming that the seller has no tax arrears.

Compliance:

- Tax registration: typically managed by the registration court
- VAT returns: monthly or quarterly
- CIT advance payments: monthly (the simplified regime may also be applied). CIT returns: annually
- Updated transfer pricing documentation: required for intra-group transactions crossing the thresholds of €20,000, €30,000 or €100,000
- Payroll reporting: annual
- Average tax dispute: 6 months-2 years (possibly more in complex cases)
- Personal liability for tax compliance: typically all board members, possibly also the financial director or the chief accountant
- Financial statements: annually
- Tax inspections: in principle announced in advance, but also random in certain cases
- Risk of enforcement: tax decisions enforceable only if final (in the case of litigation, if approved by the court)

Rates and terms:

- CIT: 19%; VAT: 23%; PIT: 18% and 32%
- Tax penalty interest: 10%
- Statute of limitation on tax arrears: 5 years
- Tax depreciation of real estate: 10/40 years
- Stamp duty on share capital: 0.5%; stamp duty on a share transfer: 1%
- The transfer of a going concern or branch of a business: VAT exempt (in the case of sale, stamp duty may be chargeable).
- Withholding tax on dividends (subject to international treaties and domestic exemptions): 19%; withholding tax on interest and royalties (subject to international treaties and domestic exemptions): 20%.

Continue reading:

>> The full report examines the key stages: start up, state aid and incentives, tax, employment and environmental issues, real estate acquisition and the construction process.

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Regulators respond to the roar of crowdfunding

By: Emma Radmore and Juan Jose Manchado

October saw initiatives in various legal systems to assess the impact and possible effects on consumers of the recent surge in crowdfunding.

First, the European Commission released a paper highlighting the fundamental characteristics and risks of crowdfunding, exploring the added value of potential EU action in this area. Then, in quick succession, the US Securities and Exchange Commission published a consultation on the implementation of the crowdfunding provisions in the JOBS Act 2012, while in the UK the FCA is consulting on how its Handbook should apply to different types of crowdfunding.

Why the sudden action?

There have been rumblings for some months that regulators were becoming interested in the levels of crowdfunding globally, most of which seems to be unregulated. The Commission's consultation is more of a fact-finding mission, aimed at collecting views on models of crowdfunding and information about current applicable national rules. From a US perspective, the JOBS Act focuses on exempting the 'equity model' of crowdfunding from registration requirements and disclosure obligations under securities law applying to start-ups and small businesses that issue shares, and from the requirement for a crowdfunding platform to register as a broker-dealer. Meantime, the UK's approach is more broad-based in the type of fundraising it affects and the requirements applying to platforms.

Crowdfunding models

Crowdfunding is typically facilitated through online platforms, some of which are bespoke or specialised vehicles run by professional arrangers and marketers, while others are more informal, seeking support through social media. Commonly, the business or individual seeking funding sets out their plans and the funds they need to raise, and interested investors can usually provide anything from a very small to a very large amount. Often, investors will get their money back if the fund-seeker fails to reach their target, but in some models this is not guaranteed. Depending on the model, investors can receive shares or debt interests in the business or project they contribute to, or enter into formal loan agreements. The easier models to understand are not based on loans, shares or debt, but instead give investors rewards in the form of goods, services such as advertising, or use of facilities. Each model has different risks and regulation impacts on various models in differing ways.

The FCA differentiates between loan-based and investment based crowdfunding platforms. For the purposes of the Financial Services and Markets Act 2000, the latter already carry out at least the regulated activity of arranging deals in specified investments, and therefore require FCA authorisation. Loan-based platforms will potentially carry on FCA-regulated activity (operating an electronic system in relation to lending) in April 2014, coinciding with the transfer of consumer credit regulation from the Office of Fair Trading to the FCA. Existing platforms that facilitate peer-to-peer lending to individuals should already be licenced under the OFT's debt administration licence category (and platforms licensed by OFT will need to apply for FCA authorisation from April 2014). As we shall see, it is loan-based crowdfunding, expanded

to include peer-to-peer lending to non-individuals, that drives the bulk of the FCA proposals. As investment-based crowdfunding is already regulated, the FCA proposes a change in its approach, to make the market more accessible, although this could have wide ranging consequences.

Investor risks

Investors may be attracted by platforms that highlight potentially higher returns than they might achieve through more traditional investments. The danger is that many if not most start-up businesses fail, and investors may not appreciate that the risk of losing their money is often greater than the 2 Volume 26 Issue 3 December 2013/January 2014 desired high returns. That said, the FCA acknowledges that for certain experienced and sophisticated investors, investment in crowdfunding initiatives could make up part of a diversified portfolio.

The main risk when investing in crowdfunding is clearly that there is no guarantee investors will receive any return on their fund and they may lose all of their money. Even where a start-up business succeeds, it will take significant time to become sufficiently profitable for its funders to benefit, so crowdfunding is not an appropriate short-term investment, and investors should not expect to be able to trade or otherwise get back their investment before term.

In its paper, the FCA identifies three sources of failure and investor harm in the crowdfunding market that regulation could do something to address:

Mispricing: the first and most crucial is the mispricing of credit and investment risk. This mispricing, or underestimation, of risk, is driven by information asymmetries, behavioural biases and/or lack of an effective secondary market. Shortage of information and due diligence on the borrower can also lead to opportunities for fraud.

Platform default: the FCA also flags the possibility of crowdfunding platform default, a risk that is compounded by a platform's need to expand quickly to cover operating costs.

Misleading promotions: in a review of 21 loan-based crowdfunding platforms, the FCA found that their website promotions did not present information in a clear, balanced and straightforward manner. In particular, it found instances of downplaying important information and misleading comparisons of crowdfunding with deposits and saving.

Regulation of loan-based crowdfunding

The paper proposes to make the new regulated activity of 'Operating an electronic system in relation to lending' a designated investment business where it facilitates a person becoming a lender under a peer-to-peer (P2P) agreement. This new regulated activity has been introduced recently in the context of the transfer of consumer credit regulation to the FCA. P2P agreements would become designated investments and their definition in the FCA Handbook glossary would be expanded to catch lending to non-individuals – in that way covering the full economic reality of what is commonly understood as 'crowdfunding', ie, the direct provision of loan finance to borrowers through platforms.

The FCA regime described below would apply no matter what amount, or for what purpose, an individual is lending to another individual or to a non-individual. The width of this proposed scope contrasts with some of the elements that, according to the

Commission's consultation, could be deemed to define a crowdfunding campaign – such as small contributions and the presence of a large number of individuals making them. Similarly, to qualify for the exemption in the US JOBS Act (in relation to crowdfunding through shares) the amount raised must not exceed $1 million and an individual's investment must not exceed a certain percentage of the individual's net worth.

In addition to the high-level standards, including the Principles for Businesses and the provisions regarding threshold conditions, approved persons, as well as systems and controls, the FCA proposes a further set of core requirements for loan-based crowdfunding platforms. Given the nature of the market failures identified in the paper, the regulator's priority is to apply an information disclosure regime similar to that applicable to other designated investments. Communications would therefore need to be fair, clear and not misleading, and comply with the requirements in the Conduct of Business Sourcebook (COBS) in addition to the rules on financial promotions. Loan-based crowdfunding platforms would need to meet certain requirements when disclosing information, initially and on an ongoing basis, about themselves and the services they provide, past and future performance, security mechanisms in place, and whenever they use comparative information, which must be meaningful and balanced. COBS would apply from 1 October 2014 to those firms currently licensed by OFT that hold an interim permission from FCA. Regarding the application of provisions on distance marketing, the FCA proposes that the period for exercising the right to cancel should start when the client registers with a platform rather than each time the client decides to participate in a loan.

Other rules in the FCA Handbook that will apply to loan-based crowdfunding platforms include:

Prudential requirements. Platforms will need to hold a minimum capital equal to the higher of either a fixed amount of £50,000 or a volume-based percentage that will decrease as the amount of funds the platform lends increases. A transitional fixed amount of £20,000 will apply until 1 April 2017. These prudential requirements acquire particular relevance in the absence of cover by the Financial Services Compensation Scheme, towards which the FCA is not proposing to make platforms contribute. Platform operators that are currently regulated by the OFT, and which may benefit from the interim FCA permission for firms transitioning to the new FCA regime, will not be required to meet any prudential requirements until they become fully authorised on 1 April 2016.

Segregation of client money. The paper notes that a platform will hold client money before it has lent it on to borrowers or before it has provided it back, in the form of repayments, to clients. The Client Assets Sourcebook (CASS) will apply in those situations.

Continuity of service in the event of platform failure. The platform must have contractual arrangements in place with another loan-based crowdfunding platform or a debt administrator, to ensure that, if it fails, loans can still be administered.

Access of clients to the Financial Ombudsman Service.

Regulatory reporting, including reports on financial position, characteristics and performance of the different categories of loans made, client money and complaints received.

Revised approach to investment-based crowdfunding

Platforms that facilitate the subscription of unlisted shares, unlisted debt securities or units in unregulated collective investment schemes (UCIS), are already subject to FCA authorisation. The FCA is currently applying restrictions on the category of investor that these platforms may offer their services to, but says it wants to make this market more accessible to retail clients. The proposed approach would from 1 October

2014 restrict the direct-offer financial promotion – by whatever media, including websites – of unlisted shares or unlisted debt securities to retail clients who:

- are certified or self-certified as sophisticated, or certified as high net worth; or
- are certified as restricted investors, declaring that they will not invest more than 10% of their portfolio in unlisted securities; or
- will be receiving advice from the platform, or where they confirm they will receive advice from another authorised person; or
- are a corporate finance or a venture capital contact.

The promotion of UCIS would be subject to the same restrictions that will apply from 1 January 2014.

Where the retail client is not receiving advice, and is not a corporate finance or a venture capital contact, the appropriateness test will apply. This would involve the platform gathering information about a client's investment knowledge and warning the client when the investment is not appropriate to his or her profile. Shares not admitted to trading on a regulated market, including those that are unlisted, are already considered a complex financial instrument under COBS 10 in respect of which non-advised sale attracts appropriateness requirements.

But debt securities, except where they embed a derivative, are considered a non-complex financial instrument whose execution-only sale has so far been exempted from the appropriateness test.

Not just crowdfunding

The FCA refers in the title of its consultation paper to crowdfunding "and similar activities". The new restriction on the promotion of unlisted shares and unlisted debt securities, as well as the expansion of the appropriateness test to the arranging of investments in unlisted debt securities, will affect execution-only channels offered by retail banks or investment services firms, along with the largely frowned upon and often illegal activity of penny share promoters and boiler rooms.

In its introduction, the FCA specifically notes the paper will also be relevant to any firm that communicates direct offer financial promotions for unlisted equity or debt securities to retail clients, where those clients do not receive regulated advice or investment management services in relation to those investments, and are not a corporate finance or a venture capital contact.

Where next for crowdfunding?

Crowdfunding is clearly gaining popularity in previously untapped jurisdictions and consumer awareness of its existence is increasing fast. Regulators are aware of this and are trying to take a proactive approach to dealing with the risks it presents in a proportionate way. The FCA has stated that it believes most crowdfunding should be targeted at sophisticated investors who know how to value start-up businesses and who understand the risks involved, including that they could lose all of their money. It wants to apply two-pronged protection among the platforms and players it regulates, so that investors are clear they have little or no protection if the crowdfund fails and stand to lose their whole contribution. It also wants to ensure those who carry on regulated activities have the right permissions – in particular, it wants firms to check that if they are handling client money they have the necessary permissions to do so. Whether this will make crowdfunding in regulated forms more popular, or less, remains to be seen, but what is clear is the increase in global regulatory interest.

This article was first published in *Compliance Monitor.*

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China publishes its most detailed competition ruling to date

By: **Alex Wang, Jim Zeng, Edward Borovikov, Bogdan Evtimov** and **Xiaoyi Tang**

On April 16, 2013, the Ministry of Commerce of the People's Republic of China ("MOFCOM") granted conditional approval to the proposed acquisition of Xstrata plc ("Xstrata") by Glencore International plc ("Glencore"), one year after MOFCOM was notified of the proposed acquisition. MOFCOM provided a detailed competition analysis in its 15-page long Glencore/Xstrata decision, and for the first time, published a detailed set of post-merger commitments from the parties involved, in the forms of structural and behavioral remedies (among other things, an extraterritorial divestiture of crown jewel mining assets) to its conditional clearance decision.

Background

Glencore, the world's largest nonferrous metal and mining product supplier, owns 33.65% of Xstrata, the world's fourth largest copper producer. After the proposed acquisition, Xstrata will become a wholly owned subsidiary of Glencore.

The merging parties first submitted their merger control filing application on April 1, 2012, which was withdrawn on November 6 after MOFCOM rejected two remedial plans proposed by the parties to resolve the concentration concerns held by MOFCOM. The parties re-submitted their merger control filing application on November 23, and the case was officially re-accepted on November 29. After two rounds of extension of the review period, MOFCOM finally issued a conditional decision to the proposed acquisition. In the MOFCOM decision, MOFCOM provided detailed competition analysis regarding the implications of the proposed acquisition on the production, supply and trade and third-party trade of copper concentrate, zinc concentrate and lead concentrate in the global market.

Despite the fact that the merged entity's market shares in China's copper concentrate, zinc concentrate and lead concentrate markets

are relatively small (they held, respectively, 17.8%, 33.3% and 21.7% of China's imports in 2011), MOFCOM determined that the proposed acquisition will eliminate and restrict competition in the China markets because China's demand for these products largely depends on imports. MOFCOM imposed both structural and behavioral remedies in this transaction. Glencore is requested to:

- Divest all of its equity interests in Las Bambas, a copper mine located in Peru that is owned and being developed by Xstrata, by June 30, 2015 (more specifically, publish a bidding announcement prior to July 16, 2013, try its best to inform MOFCOM of the potential buyer(s) of the Las Bambas project prior to August 31, 2014, reach a binding purchase and sale agreement with the MOFCOM-approved buyer prior to September 30, 2014 and close the sale by June 30, 2015);
- Auction, without a reserve price, all the equity interests it owns in one of a few alternative Xstrata projects (i.e. Tampakan, Frieda River, El Pachon and Alumbrera projects) should it fail to complete the sale of the Las Bambas project by June 30, 2015;
- Supply to Chinese customers specified minimum annual volumes (subject to adjustment based on Glencore's actual production) of copper concentrate products until December 31, 2020 at a regulated price; and
- Provide fair and reasonable market terms consistent with the then prevailing terms in the global markets with respect to supplies of zinc concentrate and lead concentrate products to Chinese customers during the period from 2013 to December 31, 2020.

Comments

This decision is thus far the most detailed merger control ruling published by MOFCOM. This case may set an example for how MOFCOM will review similar types of mergers in the future – particularly global deals in metal, raw materials, energy and agricultural commodities. There are a few lessons to learn from this case:

- Unnecessary Withdrawal and Re-filing: MOFCOM took almost twice the normal maximum statutory period allowed for merger reviews under China's Anti-Monopoly Law, which can last up to 180 days. MOFCOM's lengthy review was partly attributable to the merging parties' withdrawal and re-submission of the merger control filing, which reset the clock on the review time line and provided MOFCOM with extra time to review the transaction. As the merging parties are often listed companies in several stock exchanges and long-term pending decisions usually frustrate investors' confidence in the listed stock, the participants should engage experienced merger control lawyers to carefully draft the merger control filing documents in the first place so as to avoid unnecessary withdrawal and re-filing.

- China's Unique Multi-layered Consultation Process: Peers criticize that MOFCOM is less independent than its counterparts in other jurisdictions such as the U.S. and the EU. This case reveals a unique multilayered consultation process for a merger control review in China, which means that MOFCOM has to consult opinions from China's economic planning ministry, the National Development and Reform Commission (NDRC), relevant industry associations and even major market players. Although MOFCOM may have a weaker political status than its counterparts have, this is not unusual in the world-wide merger control practice.
- Considering Non-competition Factors: Others criticize that MOFCOM's rulings reflect not just anti-monopoly concerns but also China's own industrial policies and its concerns over access to natural resources as MOFCOM imposed a supply contract as part of the remedies. It should be noted that China's Anti-monopoly Law specifically requires MOFCOM to take non-competition issues into account – particularly a transaction's impact on national economy and national security. The fact that MOFCOM asked Glencore and Xstrata to submit two rounds of remedial commitment plans before the withdrawal, reveals that MOFCOM is more willing to work out creative and pragmatic solutions with the merging parties to clear off its concerns than simply rejecting the transaction.
- MOFCOM's Recent Release of Draft Regulations: In the Glencore/Xstrata transaction, MOFCOM requested the merging parties to dispose of an alternative set of assets in case the parties fail to divest the original asset package on time. This type of remedy should be considered in the context of MOFCOM's recent release of the draft Regulations on Imposing Restrictive Conditions on Concentrations of Undertakings (the "Restrictive Condition Rules") for public consultation. The Restrictive Condition Rules provide for three types of remedies: (i) structural remedies (such as a divestiture and sale of alternative assets), (ii) behavioral remedies (such as a supply contract) and (iii) a hybrid of both structural and behavioral remedies. The remedies set forth in the draft Restrictive Condition Rules are not common in China. MOFCOM may want to set the Glencore/Xstrata transaction as an alarming and vivid example for these new strict merger control requirements.

Conclusion

The Glencore/Xstrata transaction might just be a starting point of a more rigorous merger control in China. The remedies imposed by MOFCOM under the draft Restrictive Condition Rules can be more far-reaching. This case highlights the importance of obtaining early-stage merger advice from an experienced merger control law firm specializing in merger clearance in China.

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The changing landscape of subscription credit facilities

By: Nick Plant, Samantha Hutchinson and Elana M. Hahn

The continuing European economic uncertainty has done little to reduce the popularity of subscription credit or capital call facilities, which are liquidity products used by funds to bridge investor drawdowns. This popularity is driven by the significant benefits they provide to funds — fast and reliable access to capital, certainty of execution and enhancement of investor returns. They are also low-risk products for financiers and have strong performance. Once the preserve of a few institutions, the European fund finance market is becoming increasingly competitive with the involvement of experienced U.S. players.

The products on offer have some similarities, but there are also significant differences driven by the policies and credit criteria of lenders. These will require careful consideration by a fund manager.

Fund documentation

Typically U.S. fund documentation provides detail for the capital call package, whereas European fund documentation has tended to rely on a wide ability to borrow and secure. Ensuring any lender requirements are incorporated into the fund documentation at the outset will help to smooth the process.

Investor side-letters

These letters — whereby investors acknowledge the financing directly in favour of the financiers — are often a condition for the availability of financing for U.S. lenders. But typically they have not been required by European banks. Obtaining these letters can be a lengthy and uncertain process and, again, are most effectively dealt with if flagged early on in the process.

Security

A power of attorney and/or an assignment of the right to call-down and receive undrawn investor

commitments, as well as a pledge over the subscription accounts, are standard security requirements for this type of financing. But this package isn't obtainable in all jurisdictions or for all fund types. Establishing early on what is obtainable and how flexible a lender can be with its standard security requirements is essential.

Uncommitted lines

Many subscription finance lines are offered on a committed basis only but certain institutions offer uncommitted products, the obvious benefit being that no non-utilisation fee is payable during the life of the facility. The downside is that a fund will need to be comfortable with the fact that the facility can be withdrawn at any time, and this is where the experience, standing and past practice of the institution offering this product will need to be closely examined by a fund manager.

Fund models

Many subscription financings in Europe are provided to closed-ended funds, but some funds are moving away from this traditional private equity model to alternative models such as segregated accounts, deal-by-deal fundraising and direct-investing. Investors are looking to invest in open-ended funds attracted by the increased liquidity. These types of funds need financiers that are willing to adapt their traditional financing models to these different types of structures and able to offer bespoke and creative financing solutions. The value of subscription finance products to funds means their popularity will continue to surge, and while the increasingly competitive market offers funds more choices, the devil will be in the detail and pricing will not necessarily be the determining factor.

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Canada: Private equity basics

By: Andrea C. Johnson, Jesse S. Brodlieb and Catherine Coulter

Canada is a friendly destination for fund managers considering a first portfolio investment outside of the United States. Ease of travel and communication, as well as similar legal systems and business cultures, mean that a Canadian transaction can have the look and feel of a U.S. transaction. There are however some important differences. This article highlights some of the key differences for a U.S. fund manager to be aware of in a Canadian private equity investment.

Canadian Corporate Law

In Canada, a corporation can be incorporated provincially, or federally under the Canada Business Corporations Act. In either case, Canadian corporate statutes generally provide for greater minority shareholder protections compared to Delaware corporations. For example:

- Extraordinary actions, such as changes to share terms or a sale of all or substantially all the assets of a corporation, require supermajority approval (66 2/3% of votes of the applicable class). Extraordinary actions may also require separate votes of each class or series of shares, even if the shares are otherwise non-voting. When a separate vote is required, dissent and appraisal rights are often available to shareholders as well.
- It is not possible to carry out shareholder actions by majority written consent. Shareholder resolutions must either be passed at a meeting, or by a resolution in writing signed by 100% of shareholders. For this reason, both shareholders meetings and voting trust arrangements are much more common in Canada.
- Shareholders of Canadian corporations have recourse to the "oppression remedy". This broad remedy gives the court discretion to address conduct that is oppressive, unfairly prejudicial or that unfairly disregards the interests of any security holder, creditor, director or officer of the corporation.

While U.S. investors are sometimes wary of these and other minority shareholder protections, in our experience shareholder disputes are fairly uncommon in Canadian private equity backed companies. This is largely a factor of Canada's "loser pays" court system, as well as a less litigious environment overall.

U.S. investors are sometimes surprised that many Canadian corporate statutes require the company to have 25% Canadian resident directors, or at least one Canadian resident director if the company has less than four directors. The same minimum level of Canadian resident directors also must be present at a meeting of directors in order for the meeting to be duly constituted. The British Columbia corporate statute (as well the statutes of New Brunswick and Nova Scotia) do not have Canadian director residency requirements. B.C. has become jurisdiction of choice for Canadian acquisition vehicles in many recent Canadian private equity deals, as a result of this flexibility on director residency as well as a modernized corporate statute overall.

Qualified IPOs and Registration Rights

For many Canadian founders, an initial public offering on the Toronto Stock Exchange or even the TSX-V (the junior exchange of the TSX) is an attractive option. U.S. private equity investors, on the other hand, may expect that the company would only pursue a U.S. stock exchange

listing. It should be negotiated at the outset whether a TSX IPO is a mutually agreeable exit, and should for example trigger mandatory conversion of preferred shares.

A private equity investor in a Canadian corporation should negotiate for "Canadian" registration rights, which are similar but not identical to the standard array of U.S. registration rights. The usual model for a TSX IPO is to conduct a treasury-focused IPO initially, but follow on with a substantial secondary offering within about six months after the IPO. Canadian registration rights are therefore quite important to investor liquidity if the company does go public on the TSX.

Drafting appropriate Canadian registration rights is tricky. In Canada, securities issued before an IPO will generally be immediately freely tradable after the IPO. If registration rights automatically terminate once shares are freely tradable, an investor can find itself without any leverage to require participation in a secondary offering. It is usually not sufficient to simply clone U.S. registration rights provisions in a Canadian investment.

Canadian Tax Issues

A handful of Canadian tax issues frequently arise in cross-border private equity transactions.

Paid-up Capital

Private equity investments in Canadian corporations often require special steps to maximize the "paid up capital" (PUC) of their shares. Structured properly, investors should be able to obtain shares having PUC equal to the value of their investment. PUC is valuable for a couple of reasons:

- On a redemption or buy-back of shares, the buy-back amount in excess of the PUC of each share will be treated as a dividend for Canadian tax purposes, resulting in withholding tax at a statutory rate of 25%. The withholding tax rate may be reduced by treaty, provided benefits are available.
- In Canada, a corporation can return capital without having to pay dividends. A return of capital is not subject to Canadian withholding tax, provided that it is backed by sufficient PUC.

PUC is averaged across shares of the same class or series, regardless of the number of shareholders or how much they paid for their shares. Maximizing PUC often requires the creation of separate share classes, or even the use of a special purpose acquisition vehicle, solely for tax purposes. "Straight" common share investments are therefore rare in Canada.

CCPC

A CCPC or "Canadian-controlled private corporation" is a corporation incorporated in Canada that is not controlled by any combination of non-residents of Canada and/or public companies. There are many tax benefits to CCPC status for both the company and Canadian-resident founders/shareholders. The main benefit for the company (and indirectly for its investors) is the availability of refundable, preferential rate Scientific Research & Experimental Development Investment Tax Credits (ITCs). Refundable ITCs can be a critical source of financing. Structures have been developed that can preserve CCPC status even in the face of significant investment by U.S. or other

non-resident private equity funds. However, these structures can be complex and do require flexibility on the part of non-resident investors in terms of governance and control of the portfolio company.

Blocker Entities

Historically, it was common for U.S. private equity investors to invest in Canadian target companies through a "blocker" entity incorporated in a third country with a favourable tax treaty with Canada, often the Netherlands or Luxembourg. Generally, this was done to avoid cumbersome reporting requirements that applied to sales of Canadian private company shares by non-residents. While changes to Canadian legislation in 2010 largely eliminated the impetus for this structure, in some cases the limitation on benefits provisions of the Canada-US tax treaty, among other reasons, have some U.S. private equity investors still consider using third country blockers. Caution should be exercised, however, as the Canadian government has announced its intention to crack down on so-called "treaty shopping" structures using third country blockers. To date, no draft legislation has been released.

Canadian Employment Issues

U.S. investors are often surprised by Canadian founders' expectations for relatively generous packages on termination of employment, and in particular for fairly lengthy periods of notice of termination. Canada has no concept of "at will" employment. In addition, Canada generally has an employee-friendly environment. Larger-scale or "mass" terminations can also trigger additional severance liabilities. Employment due diligence to quantify potential severance and termination liabilities is important in a Canadian transaction, particularly if a reduction of workforce is anticipated.

Some of the employment issues which U.S. investors should be aware of include the following:

- Each Canadian province has basic minimum termination pay standards which must be honoured in the event of a termination without cause. Those standards often look something like 1 week of notice or pay in lieu of notice per year of employment, but they are generally capped at 8 weeks. The province of Ontario also requires certain employers to also pay statutory severance to longer term employees, equal to an additional 1 week of severance per year of employment but capped at 26 weeks. Under no circumstances can Canadian employers provide employees who are terminated without cause anything less than their statutory minimums.
- It is possible to restrict employees to their statutory minimums on termination, but only if the employee and employer have properly entered into an employment agreement which expressly limits the employee to those minimums.
- In the event of a mass termination of a number of employees over a short period of time, the statutory notice minimums increase, and an employee ordinarily entitled to just 1 or 2 weeks of statutory notice might be entitled to at least 8 weeks of statutory notice. The calculation of notice in the event of a mass termination will depend upon the province where the terminations take place as well as the number of employees affected by the mass termination.

- If a termination provision is set aside by the courts or if the employee is not subject to a termination provision at all, Canadian courts will award the terminated employee a larger amount of notice, which is called "common law notice" in most provinces. Common law notice is a discretionary amount determined with reference to such factors as the employee's length of service, position, seniority, age and ability to find a comparable job. While there is no rule of thumb which applies to calculate common law notice, it is not unreasonable to expect that many employees may be entitled to as much as 1 month of notice or pay in lieu of notice for each year of service. As a result, it is important that employers enter into proper employment agreements with their employees whenever possible, and investors should turn their minds to the state of the company's employment agreements when considering an investment.
- Restrictive covenants can be difficult to uphold against Canadian employees. The courts in Canada view non-competition covenants as a restraint of trade, and will generally strike them down if they should not have been entered into or if they are overly broad as to geographic scope and/or duration. Greater latitude is often given if the agreement is entered into in connection with the sale of a business. Canadian courts will not "read down" or "blue pencil" non-competition provision in the same way that some U.S. courts will. Non-solicitation covenants are easier to uphold than non-competition covenants, but only if they are reasonable in scope and duration.

On the good news front for U.S. investors, benefit plan issues tend to not be nearly as significant in Canada as in the U.S. This is due to the fact that Canadian healthcare is essentially a publicly funded of series of socialized health insurance plans which provide coverage to all Canadian citizens. As a result, any benefits coverage offered by employers is usually restricted to cheaper items not covered by the Canadian healthcare system, such as dental, medication, disability and life insurance coverage. Because all Canadians have a right to medical treatment and hospitalization under the Canadian health care scheme, Canadian employers do not need to pay for them as part of their benefits plans.

With forethought, Canadian-specific issues are usually manageable with relatively minor adaptions from standard U.S. private equity transaction documentation.

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Private equity in Central and Eastern Europe and Germany

By: **Piotr Dulewicz, Pawel Grabowski, Robert Bastian** and **Dr. Volker M. Junghanns**

The emergence of a vibrant private equity sector in Central and Eastern Europe (CEE) did not happen overnight or by accident. The last two decades have seen strong growth, increasing market demand and stable macroeconomic indicators, as well as a flourishing entrepreneurial culture, which have all contributed to the development of a robust institutional, legal and business environment in the region.

Introduction

Low corporate taxes, low labor costs and a well-educated workforce combined with the borderless access and heavy development spending brought by membership in the European Union to kickstart the region's economic step-change. This has been an attractive mix for foreign direct investment. EU integration has also played a vital role in regularizing and instilling faith in CEE legal and accounting systems. Tax reforms across the region created incentives for investors and businessmen alike. Harmonization of national laws with EU legislation resulted in changes to local law and regulations that stimulated the business environment. Economic growth and widespread legal and fiscal reforms have contributed to the development of a new generation of entrepreneurs seeking to benefit from the region's many plus points.

Mature private equity market

The private equity market in CEE has all the necessary architecture in place to support the private equity investment lifecycle.

In addition to a developed tax and legal structure, the region offers experienced banks, accomplished region-dedicated peneral partners and professional legal and financial advisers. Today's private equity market is equipped with a variety of funds—including mezzanine—as well as experienced fund managers employing versatile investment strategies. Buyout and expansion, venture capital, distressed strategies—investors have a wide variety of investment options on hand.

Market challenges and opportunities

After a downturn in the deal flow in 2013, most private equity players in CEE are optimistic about a return to PE-driven M&A in 2014. Funds are looking especially to Poland, the Czech Republic and Slovakia as premier locations for their investments in the region. Lower investment costs coupled with modern management systems give a competitive edge to companies that provide services and manufacture products for both regional and Western markets. Developing these portfolio companies is seen, together with new investments, as the key force pushing the PE sector forward.

The private equity market in CEE is a challenging environment for funds seeking large transactions though. 2013 saw a few encouraging exits, such as the €400 million sale of Lux Med, the largest private health care provider in Poland. Still, such deals are scarce in the region, as funds need to compete with global players and strategic investors. Fortunately, the sector can boast significant activity when it comes to mid- and small-cap deals, mainly due to consolidation trends in the consumer goods and retail, TMT, IT, health care and pharmaceutical sectors. This trend for cross-border sector consolidation coupled with numerous company formations make the deal flow potential more than positive.

We have also witnessed recently a recovery on the public market in Poland, and the trend of IPO exits may soon spread into the region.

While predictions of fundraising and M&A activity in Central Europe are also optimistic, investors are increasingly selective when it comes to investing. Fierce competition, tight regulations and uncertainty on the financial markets have all made limited partners more demanding when choosing fund managers. The abundance of funds on the European market has made the competitive conditions of fundraising even tougher.

Alternative investment rules

Regulatory pressure on the European markets has increased after the implementation of the Alternative Investment Funds Manager Directive (AIFMD), which has made capital-raising and PE investments even more complex.

The regulatory requirements have impacted managers that manage and/or market alternative funds in or from the European Union, regardless of fund domicile.

The new regulations impose additional costs and compliance burden on managers in many operational and organizational areas, such as risk management, remuneration policy, valuation, depositary, delegation and transparency of reporting.

The German experience

While private equity in CEE is a comparably young industry, in Germany it matured as a market some 20 years ago. That said, the German market is struggling with its own peculiarities. The tax regime is generally regarded as less favorable for private equity or venture capital funds than other European jurisdictions and the 2013 federal elections did not give a positive signal for an upswing in the industry. At present, there is a discussion about full taxation of carried interest, which would worsen the situation still further.

Private equity investments declined in 2013 after having risen for three years in a row. The strong business performance seen in the buyout business in particular at mid-year tailed off toward the end of the year and investment volume finally fell to €4.68 billion, down from its 2012 post-crisis high of €6.63 billion. However, it is a long way off its all-time high during the "golden age" of 2005–2007. Accounting for most of the investments were leveraged buyout deals (at €3.59 billion), in particular in the small and mid-cap markets. Large-cap transactions were few and far between, and some will only be finalized during 2014. Transactions were down in number terms from 116 in 2012 to 86 in 2013. Only the venture capital segment (seed, startup and later-stage investments) bucked the negative trend, with almost 1,300 companies receiving combined financing of €673 million from venture capital sources (2012: €567 million). On the fundraising front, newly acquired fundraising continues to decline as the number of buyout and venture capital funds has dropped. Buyout funds managed to raise funds of €630 million (versus €1.56 billion in 2012), while venture capital funds closed at €440 million (17 percent up on 2012). The overall number of funds closed was low. (All numbers from the German Venture Capital Association [BVK]).

2014 German private equity outlook

The outlook for private equity in Germany in 2014 is less optimistic, but still mildly positive. While buyout financing terms and conditions showed positive development thanks to a robust (and for the future, even more promising) German economy, the number of possible target companies is critical but expected to improve over the next few months. This is due to the fact that a huge number of family-owned businesses face succession problems. Even though family owners remain wary vis-à-vis financial investors, they have scant alternatives as other sources of financing (such as banks and capital markets) remain limited. It is as yet unclear whether new market players, such as debt funds, will play a major role over the next few years. Also, many private equity funds are now at the end of their lifetime, and therefore the number of secondaries is expected to rise. Finally, there is no end in sight to low interest rate policies, meaning that financial conditions, especially in the buyout sector, are likely to remain favorable.

Another trend is the consolidation of the industry. While some funds have simply reduced their teams, a number of GPs were unable to raise money for new funds and have left the industry. Former team members are often forming new alliances and investing together with family offices or on a "friendly investor" deal-by-deal basis.

Conclusion

The CEE region has now matured sufficiently in terms of private equity investments to be put on a par with Western Europe when it comes to business development and investment strategy patterns. Despite the competitive PE environment, tight regulations and lack of political and economic homogeneity of the markets, private equity firms are unanimous in their optimistic predictions.

Interestingly, cross-border financing between Germany and the CEE region is seemingly on the rise. While historically, German-based funds have often looked in the CEE region for anchor or add-on transactions, the trend in recent years has seen investments come from the CEE region and look for add-ons in Germany.

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Insurance coverage (or not)

By: **Jessica Duggan** and **Stephen M. Fields**

After looking at numerous investment opportunities, you bite the bullet, assemble a syndicate of lenders and close on a leveraged buyout transaction resulting in control of the operating company target through the use of a holding company. You were careful in your diligence, having conducted a Phase I environmental investigation, with nothing significantly adverse to report despite the regular use in its business by the target of certain contaminants. Now fast forward, and, five years later, you have received an attractive offer to buy your interest from a strategic buyer. The buyer and its lenders proceed to conduct their own due diligence and, lo and behold, the contamination levels that were previously below reportable levels have, according to the buyer, exceeded permissible levels and have now reached groundwater. What is the consequence of this? How did it happen? Who caused it? What are the issues?

At the outset, is the verbal report from the buyer complete and accurate? Is there a lab report or confirming consultant report, in draft form or otherwise, in existence to support the allegation? What is the remediation cost and how long will it take? Have you violated any federal or state laws and are you continuing to do so? What obligations do you as the majority owner and current indirect operator of the tainted property have and to whom? Do you have any indemnity rights against the former owner? Did the contaminated groundwater migrate from an adjoining property? Will it migrate further into public drinking water? What insurance do you have and does your pollution policy cover the existing situation? In addition, the buyer and its lenders have become nervous about the entire transaction, and, if they proceed, now wish to exclude the tainted facility from the purchase and are requesting a separate escrow, indemnity and insurance coverage.

Lots of questions—lots of uncertainty. What should you do and what are your alternatives?

First, you must ascertain the facts. The buyer has made an allegation which may or may not be true or be as severe as claimed. It hired a consultant which undoubtedly has an economic interest in participating in an expensive remediation effort. Do you want the buyer to control that process? If it proceeds with the purchase, the buyer itself is incentivized to reduce the purchase price and to create as large an escrow and indemnity as possible. Under many state and federal environmental statutes, once an owner or operator becomes aware of an "environmental condition" it has an obligation to promptly report same to the local authorities, which will then undertake their own investigation and make recommendations and/or issue directives as to what is required to remediate the property. The obligation to report an "environmental condition" to the local authorities does not generally arise until a final written report is rendered by someone expert in the field. As a result, a seller will often immediately engage its own expert for such purpose so as to control the process and costs involved and to initially render a draft report. If a pollution insurance policy is in place, in order to preserve coverage, you as the seller should immediately notify the insurer—especially if you wish to be reimbursed for any costs you incur, because the insurance company will want to be responsible for the cleanup and hire those who will do such work because of the discount it receives due to its ability to purchase in volume. It is also recommended that, in collaboration with the buyer,

a formal claim be made with the insurer before signing any purchase documents with the buyer so as to preserve such insurance coverage because numerous pollution policies have non-assignment provisions and so-called "contractual liability exclusions" from coverage which are triggered upon entering into indemnity agreements with the buyer. You also need to check whether a change of control is deemed to be an assignment under the policy. In the scenario outlined above, the buyer (which will purchase the entity that previously operated the tainted property) and you as the seller (if you retain the contaminated property in a different entity) will no doubt seek to obtain your own pollution policies. (Note that if you as the seller retain the tainted property as a stand-alone in a separate entity, it is possible that such entity will be treated as a real estate holding company and thus Foreign Investment in Real Property Tax Act [FIRPTA] rules will apply to any foreign limited partners of yours, which may require them to file US tax returns.) Note also that buyer and seller will need to be aware of something the insurers call a "material increase in risk endorsement" provision contained in many pollution policies. Thus, in the example above, if the contaminated groundwater continues to migrate in the future, it is possible that the insurance coverage purchased will be disavowed by the insurer. Another caveat is that some of these policies permit the insurer to cancel the policy for any reason or no reason, usually upon 90 days notice. As is apparent, careful review of the policy is essential.

> Lo and behold, the contamination levels that were previously below reportable levels have, according to the buyer, exceeded permissible levels and have now reached groundwater. What should you do and what are your alternatives?

Assuming an environmental disaster is not covered by insurance and indemnity rights are not available from a creditworthy indemnitor, do you as the private equity fund seller have exposure simply because you are the majority stockholder of, and control the board of, Holdco (a Delaware corporation), which is the sole member of Opco (a Delaware LLC), which previously operated the tainted property? Generally, environmental law respects the limited liability of the corporate form unless specific, unusual circumstances justify treatment of the business as a separate entity. There are two ways in which shareholders may potentially face liability: piercing the corporate veil, or where the shareholder is deemed under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and similar state statutes to be an "operator" of the subject property under environmental regulations. Neither of these doctrines applies solely because a seller is a shareholder. Certain courts (the Fifth Circuit for example) take a narrow view of corporate veil piercing in environmental liability actions. However, if the corporation is formed to perpetuate a fraud or where the shareholder's activity resulted in the liability, a shareholder could be held liable. While the rules of veil-piercing limit derivative liability for the actions of another entity, CERCLA's "operator"

provision is primarily concerned with direct liability for one's own actions. As a result, an officer, employee or shareholder could potentially be liable if "they themselves actually participated in the wrongful conduct prohibited by the Act." *Riverside Mkt. Dev. Corp. v. International Bldg. Prods., Inc.*, 931 F.2d 327, 330 (5th Cir. 1991). Liability does not extend merely because management had authority to operate or make day-to-day decisions. Board control does not change this analysis. "Operator" liability extends only to those "persons" (including corporations and other entities) who "managed, directed or conducted operations specifically related to pollution, that is operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations." *United States v. Bestfoods*, 524 U.S. 51, 66-67 (1998).

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It's not what you know, it's who you know

By: **Zoë Thirlwerl** and **Václav Žalud**

In a recent case, the Supreme Court of the Czech Republic (SCCR) was asked to consider and interpret Art 40 of Council Regulation (EC) No 1346/2000 on Insolvency Proceedings and its application to "known creditors".

With the UK deciding to opt in to the negotiations of the "Proposed changes to the European Regulation on Insolvency", it has been suggested that the identification of, and notification to, known creditors may give rise to some increased uncertainty regarding foreign creditors' rights to challenge.

Article 40 aims to improve the supply of information provided to those "known creditors" who have their habitual residences, domiciles or registered offices within the European Union and where that habitual residence, domicile or registered office is in a member state, other than where insolvency proceedings have been initiated. It links with and follows Art 39, which gives such creditors the right to lodge claims. So, Art 40 gives known creditors the right to receive an individual notice and be informed of what they are required to do to lodge their claims in the insolvency proceedings, including any relevant time limits.

The Czech case of *Sahin v QSN24h*, confirms that the right to such notice arises even in cases where, as in the Czech Republic, notice of the insolvency and the relevant time limits are available through an online register. It is now pertinent to consider the effect of decisions surrounding Art 40 and the potential impact on information to be given to community creditors in light of the proposals to amend the European Insolvency Regulation (EIR).

Czech Insolvency Law Background

Sahin caused controversy as, despite regulation existing at a EU level, the SCCR (as the court of last instance), took the opportunity to interpret the term "known creditor" used in Art 40, without referring the case to the European Court of Justice (ECJ) for a preliminary ruling. In reaching its decision, the SCCRheld that a "known creditor" is any creditor habitually resident, domiciled or with its registered offices in a member state (other than Denmark) who, in the ordinary course of the insolvency proceedings, would have been identified as a creditor of the debtor by the Czech insolvency court (the Insolvency Court) or the preliminary or permanent insolvency trustee.

They would have been identified from:

- the debtor's insolvency petition and in particular the accompanying list of debts which must, under Czech procedures, be filed with it;
- the debtor's accurate bookkeeping; or
- other properly maintained evidence of the debtor's assets and liabilities (including correspondence).

The proper interpretation of Art 40 is particularly important in member states such as the Czech Republic, where almost all the documents regarding the insolvency proceedings are immediately available online. The use of online registers throughout member states varies widely from a similar system in the Netherlands, through to Greece and France, which don't have any electronic insolvency registers. In the Czech Republic, creditors must normally register their claims within the deadline set by the Insolvency Court in the decision on declaration of insolvency. This deadline is typically between 30 and 60 days from the publication of the notice on the online insolvency register. An exception applies to

"known creditors" from other member states (except Denmark) who may register their claims later, usually within one to two months from the delivery of an individual invitation (pursuant to Art 40) on a special form sent by the court or by the trustee. This process (and its relatively short deadlines) is designed to speed up most insolvency proceedings.

Lemmel: Fraudulent Omission

Sahin was not the first time the Czech appeal courts considered the registration of claims by foreign creditors from other member states. The High Court in Prague (on appeal from a decision of the Insolvency Court), previously held in 2010, that when the debtor withheld information regarding a foreign creditor, with the intention of avoiding the registration of additional claims in pending insolvency proceedings, it would violate the principles of justice to dismiss a claim registered after the time limit for registration had expired (Jens Lemmel, 1 September 2010 No. 3 VSPH 173.2010).

In *Lemmel*, a German creditor of a Czech debtor was not notified in accordance with Art 40. The German creditor became aware of the insolvency, and that the relevant time for the registration of claims had expired. Nevertheless, it filed a proof of its claim. The Insolvency Court dismissed the claim, but it was overturned on appeal. The High Court ruled that, where a debtor fraudulently omitted to name a foreign creditor in its insolvency petition, that creditor should be considered a "known creditor" for the purposes of receiving a notice under Art 40 and referred the case back to the Insolvency Court for further review.

Sahin: Negligent Omission

There was no allegation of impropriety in *Sahin*, merely negligence by the debtor in its bookkeeping duties. QSN24h, sro, a Czech limited liability company, was declared insolvent in October 2008, following an insolvency petition filed in August 2008. Mr Sahin, QSN24h's sole shareholder and a German resident, filed a proof of his claim in QSN24h's insolvency estate almost one year after the expiry of the time limits for registration of claims. Mr Sahin argued that the time limit should not apply to him, as he was a "known creditor". He argued that his claim should have been recorded in QSN24h's books and that he should, therefore, have received notification of the insolvency and the time limit on making claims pursuant to Art 40. Both the Insolvency Court, and the High Court on appeal, dismissed Mr Sahin's application.

Mr. Sahin then filed an extraordinary appeal to the SCCR. The SCCR affirmed its previous case law, abrogated the two lower decisions and referred the case back to the Insolvency Court. It held that a debtor who fails to maintain proper records in its bookkeeping, or fails to submit complete lists of its debts to the Insolvency Court within its insolvency petition, should not be capable of benefiting from its own negligence in respect of creditors from other member states. The SCCR held that if the debtor had not been negligent (eg, in its book keeping) creditors, who would otherwise have benefitted from the provisions in Art 40, would have been known to the Insolvency Court. The SCCR held that when a creditor later becomes "known", it is entitled to be notified pursuant to Art 40, and the time limits start to run from that point.

Omission For Other Reasons

The decisions in *Sahin* and *Lemmel*, provide answers in relation to fraud and negligence. However, they do not answer the question as to whether the requirement to

receive an individual notice applies to member state creditors whom the debtor has neither fraudulently nor negligently omitted, but has omitted for other reasons. In *ECM Real Estate Investments AG*, pending before the Prague Municipal Court (having jurisdiction over the case as the Insolvency Court), the Czech insolvency trustee initially rejected claims registered by the representative of the holders of EUR bonds issued by the company. The trustee argued that the representative elected by the EUR bondholders to represent their interests, lacked the capacity to register claims under the EUR bonds in the insolvency proceedings. The trustee argued the registration of the EUR bondholders' claims against the company should have been registered by CACEIS BANK Luxembourg SA (the bank) and not the representative. The bank was the principal paying agent and common depositary (or custodian) of two permanent global bonds representing the EUR bonds, but with no monetary interest in such bonds.

Although the Insolvency Court did not have to consider the trustee's position (as the parties reached a settlement), it is possible to consider, in light of *Sahin* and *Lemmel*, whether the bank would have been considered a "known creditor", pursuant to Art 40, and whether it should have been individually notified about registering the claims. For over a year, neither the trustee, nor the Insolvency Court, sent the bank notification to file its claim. If it were held that the bank was not a "known creditor", the bank would not benefit from the exception under Art 40 and the rights of the bondholders would have been seriously jeopardised by the decisions of the Insolvency Court and the trustee. If there was no settlement before the consideration of this issue, such a situation where the creditor becomes "known" at some point during the insolvency proceedings (and not as a result of negligence or fraud) would require resolution by the Czech courts and, ultimately, maybe even the ECJ.

Practical guidance

The Czech cases provide guidance on the position in cases of negligence and fraud, but leave a question of doubt if, eg, a dispute arises as to the standing and locus of the creditor. If another (foreign) party, not given individual notice of the insolvency, becomes aware after the date for registering claims that they are a creditor, they will not, at the relevant date, be in a position to claim and will not receive notice of the insolvency event.

Czech practitioners consider the SCCR's leniency controversial: the strict time limits imposed by the public policy of wanting fast resolution to insolvency proceedings would not apply to creditors within the member state of whom the trustee subsequently became aware. They would not be "known creditors" under Art 40. The SCCR's decision potentially gives "known creditors" from outside the member state additional protection regarding their claims, as against local creditors. This raises the question as to why the company's local creditors should be disadvantaged, and potentially have their claims diluted, because of the company's negligence (not their own). Following this decision, some creditors appear to be more equal than others.

The proposed amendments to the EIR provide that the duty under Art 40 to inform "known creditors" immediately of the insolvency proceedings, will be supplemented by a requirement that the office holder must include a copy of a "standard claims form" (or a link to it) in its notice to creditors (revised Art 40(2)). The standard claims form will be published on the European e-Justice Portal by the date that the majority of the revised EIR becomes effective (revised Art 41(1)).

The amendments also provide that each member state must establish one or several internet-based registers available to the public free of charge. Given that the UK already has the London Gazette and Companies House registers, these amendments will require some upgrades, but the framework is there. However, it seems unlikely that filing notices of insolvencies on such internationally available registers will satisfy the court or the insolvency practitioner's obligations under Art 40 to notify "known creditors" individually of their rights. It would require the foreign creditor to search for that information.

When acting for creditors of a Czech or other EU debtor, it is vital for practitioners to inform themselves quickly about the relevant deadlines, as these may be considerably swifter than those of the jurisdiction they are used to. When acting for a creditor whose claim has not (yet) been admitted for proof, advisers may be able to take some comfort in the Sahin decision, absent an ECJ ruling on the matter.

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The JOBS Act: An update

By: Rani Doyle, Marc H. Mandel and Walter Van Dorn

Overview

The Jumpstart Our Business Startups (JOBS) Act became law in April 2012. Its major provisions were to:

- Create an IPO "on-ramp" for a new class of registrants called "emerging growth companies" (EGCs)
- Permit general solicitation in offerings under Rule 506 and Rule 144A, provided sales are made only to persons reasonably believed to be qualified
- Create an offering exemption for crowdfunding transactions
- Create an exemption for offerings not exceeding US$50 million within the prior 12-month period
- Raise thresholds triggering registration obligations under the Exchange Act

Some of the initiatives under the JOBS Act have been suggested by market participants for many years in light of the significant changes to the markets and the ways people and companies communicate information. In key ways, Title I of the JOBS Act represents the latest stage in the evolution of the SEC's regulation of issuers according to their "categories"—meaning, generally, regulations scaled to the nature and size of an issuer's business, offerings and the trading markets for its securities.

Whether categorizing issuers or offerings for purposes of Regulation S, eligibility for short-form registration or "ondemand" registration, the challenge for the SEC has always been how to adopt more efficient capital raising techniques in balance with its need to protect investors all within a coherent regulatory framework. This challenge is perhaps one reason why the SEC is taking more time than expected (at least by Congress) to adopt many of the more interesting provisions under the JOBS Act, such as lifting the ban on general solicitation or advertising for offers and sales under Securities Act Rules 506 and 144A and proposing rules to permit crowdfunding. While Title I has already had a measurable impact on the IPO environment, it may be that the elements of the JOBS Act that the SEC has yet to effect will have an even greater impact on the capital markets—both in the US and globally.

EGCs have filed a large majority of the IPOs so far this year and the IPO on-ramp provisions in Title I are being widely used. To provide an update on this use, we completed a random survey of 90 of the approximately 400 IPO filings by EGCs between January 1, 2013, and June 25, 2013, approximately 200 of which were declared effective during that time period. Here is what we learned:

The IPO on-ramp is increasingly well-trafficked, with a majority of EGCs taking advantage of many of the accommodations provided:

- Although not yet a majority, EGCs that did not describe themselves as either "development stage" (which we define in more detail below) or speculative companies seem to be increasingly relying on the ability to present two, rather than three, years of audited financial statements. EGCs that are also "smaller reporting companies" (SRCs) more frequently present two years of audited financial statements.
- A significant majority of EGCs disclosed their intention (or ability) to defer having their auditors attest to the effectiveness of their internal control over financial reporting.
- A large minority of the EGCs we surveyed disclosed their election to comply with new or revised accounting standards applicable to public companies, thus rejecting

the relief under the JOBS Act to comply with such standards only when they are applicable to private companies. The EGCs driving this result tended to be larger companies that did not describe their business as being in the "development stage."

- A large majority of EGCs, both larger companies and smaller reporting companies, did not provide a Compensation Discussion & Analysis (CD&A), or a level of disclosure that would come close to complying with S-K Item 401(b), and relied on scaled compensation disclosure requirements already applicable to smaller reporting companies.
- Many EGCs submitted draft registration statements on a confidential basis.

EGCs exist in good numbers across industries including health care and pharmaceuticals (19 percent), services (18 percent), financial and insurance (16 percent), construction and real estate (10 percent), energy and natural resources (10 percent), technology and telecommunications (9 percent) and industrial and manufacturing (7 percent), with the balance relating to wholesale and retail, agriculture and livestock, transportation and other industries.

There are clear overlaps between EGCs and SRCs and EGC/SRCs and development stage companies (DSCs). We define development stage companies as those that are highly speculative or that have been in existence for less than a year.

- 41 of the 90 researched identify as both EGC and SRC.
- 23 of the 41 EGCs/SRCs also described themselves as DSCs:
- See, e.g., Camp Nine, Inc. and Lion Consulting Group.
- Several of these self-described EGCs/SRCs/DSCs present less than one year of audited financial statements, have one or two executive officers, have boards comprised of three or fewer members and seek to raise proceeds of US$200,000 or less.

Many EGC IPOs are underwritten by well known investment banks on a firm commitment basis, seek a listing on the NYSE or Nasdaq and are audited by a "big four" accounting firm. Some of these include:

- Domestic companies: Phillips 66 Partners LP; Bright Horizons Family Solutions, Inc.; RetailMeNot, Inc.; Gogo, Inc.; Evertec, Inc.; LipoScience, Inc.; Portola Pharmaceuticals, Inc.; PTC Therapeutics, Inc.; TriState Capital Holdings, Inc.
- Foreign private issuers: Knot Offshore Partners LP; QIWI plc; FleetMatics Group PLC (selling shareholder offering); UBIC, Inc.
- REITs: Rexford Industrial Realty, Inc.; ZAIS Financial Corp.

More EGC IPOs in our sample are made on a self-underwritten, best efforts/continuing basis, to raise proceeds of less than US$50 million—in many cases far less than that amount.

Of the 90 EGCs we surveyed, 17 indicated a listing on the NYSE, 25 on Nasdaq (includes all three market tiers), 13 on the OTC markets and pink sheets, five on Canadian exchanges and one on a foreign exchange. The remainder did not indicate any market.

Foreign private issuers (FPIs) are identifying as EGCs and utilizing the accommodations made available to them as such (and also as FPIs). Six of the 90 researched disclosed they were foreign private issuers.

Our survey indicated that EGCs generally fall into three groups:

- The first category comprises EGCs identifying also as SRCs and DSCs. Companies in this group are making highly speculative offerings and providing materially less disclosure than the two other categories of EGCs.
- The second category is the EGC/SRC group, which is generally utilizing most of the disclosure accommodations for SRCs and EGCs.
- The third category is the EGC group. These companies tend to be larger with higher revenues and use fewer EGC disclosure accommodations than the other two EGC groups we observed.
- It will be interesting to see whether these observations hold over time.

The state or jurisdiction of issuers of all EGC IPOs filed between January 1, 2013, and June 23, 2013 shows some interesting concentration information: Delaware, 39 percent; Nevada, 30 percent; Maryland, 10 percent; other states,17 percent; and foreign countries, 4 percent.

Continue reading:

>> The full report further reviews the JOBS Act, looks at recent emerging growth company filings with the SEC and provides an analysis of EGCs and smaller reporting companies.

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