Simmons & Simmons

Securities & Derivatives

July 2006
Issue No.68
www.simmons-simmons.com
www.elexica.com

Side letters and the Financial Services Authority (FSA)

The FSA has issued a Feedback Statement on its June 2005 discussion paper entitled "Hedge Funds: A discussion of risk and regulatory engagement".

The overall impact of the Feedback Statement is relatively benign for the UK hedge fund management industry – the FSA is, to a large extent, preserving the status quo and has not proposed any new rules that would radically increase the regulatory burden for FSA-regulated hedge fund managers.

However, the one significant issue of concern is the FSA's approach to investor side letters.

The FSA says that each time an FSA-regulated hedge fund manager enters into a side letter with an investor in one of the fund manager's funds, the hedge fund manager must disclose (to all other investors in the relevant fund) the fact that a side letter has been issued and then manage adequately any conflicts of interest that may arise. The FSA says that a failure to do so constitutes a breach of Principle 1 of the FSA's Principles for Businesses (which imposes on firms a duty to conduct their businesses with integrity) and has hinted that it may regard a failure to disclose as 'dishonest concealment' under s. 397 of the FSMA, giving rise to potential criminal liability.

Our concerns are as follows:

- The announcement of this disclosure requirement effectively introduces back-door regulation of the funds themselves via the hedge fund manager.
- The disclosure requirement lacks granularity. It does not seek to distinguish between side letters to which the hedge fund manager is party and those where the fund manager is not and does not distinguish between side letters that merely record the exercise by the fund manager of a discretion in circumstances where that discretion is clearly set out, and therefore disclosed, in the prospectus (and which could just as easily be recorded in a board resolution), from those that purport to vary the normal rights that an investor would have under the terms of the prospectus or the fund's constitution.
- This is not a new rule – just the FSA's newly-articulated interpretation of Principle 1 – so the disclosure requirement set out in the feedback statement already applies to FSA regulated hedge fund managers which means that existing side letters may need to be dislocsed.
- The disclosure requirement assumes that the hedge fund manager knows the identity and contact details of all of the investors in the fund, in order to make the disclosure. In practice, this may not always be the case and the hedge fund manager may have no right to access this information.
- The FSA has been very clear to point out that hedge fund managers do not need to disclose the contents of their side letters or the name of the relevant investor – just the fact that a side letter has been entered into. So there is an increased regulatory burden for little or no obvious benefit to investors.
- Finally, differential treatment of investors is not an issue that is peculiar to the hedge fund industry. Side letters are also widely used in the private equity sector and institutional investment managers frequently agree different terms with their clients. Why has the FSA made the point specifically in relation to the hedge fund industry?

If you would like further advice in relation to the issues discussed above please contact Darren Fox
E darren.fox@simmons-simmons.com
T+44 (0)20 7825 4069.

Court of Appeal gives wide interpretation to "financial institution"

The capital markets will be pleased with the decision of the Court of Appeal that in cases where the assignment of loans is restricted to "banks or other financial institutions", a wide interpretation should be given to what may be counted as a "financial institution".

In The Argo Fund Ltd v Essar Steel Ltd [2006] EWCA Civ 241, the Court of Appeal has held that the words "other financial institution" in the 1997 LMA standard syndicated loan agreement did not need to be a bank or even akin to a bank. The context was whether an assignment of the lenders' rights and obligations had been properly made since the terms of the transaction restricted any such assignment to entities which were "a bank or other financial institution".

The facts were that in 1997 Essar Steel Ltd ("Essar") entered into an unsecured syndicated loan agreement in the standard 1997 Loan Market Association form as borrower with a syndicate of nine banks and financial institutions.

The Argo Fund Ltd ("Argo") was a Cayman Island investment company which held and managed funds. At all materials times, it had a portfolio of debt, including bonds, loans, letters of credit and promissory notes, mainly purchased in the secondary debt market from other institutions.

By 1999, Essar was in financial difficulties, and in 2003, Argo offered to acquire from the syndicate all Essar's outstanding debt under the 1997 agreement. A number of members of the syndicate accepted Argo's offer and, by June 2003, Argo claimed to have purchased Essar's debt under the agreement.

Essar argued that the transfers by the members of the syndicate to Argo were void because Argo was not "a bank or other financial institution" as required by the agreement, and therefore was not a permitted transferee of the syndicate's rights under it. The judge at first instance found that a "financial institution" was one that had at least some characteristics of a bank and that Argo had sufficient characteristics to qualify as a transferee. Essar appealed.

The Court of Appeal dismissed the appeal for the following reasons:

- "other financial institution" in this context need not be a bank or even akin to a bank; and
- it was not necessary for a transferee's business to include bank-like activities, such as the lending of money, whether on the primary or secondary debt market or otherwise, or indeed that it should exhibit any particular standard of suitability or probity as a financial institution.

Argo therefore qualified as an "other financial institution" and was entitled as a transferee to claim repayment.

It is also worth noting that the relevant LMA wording has now been amended to state that a lender may assign any of its rights or transfer by novation any of its rights and obligations under any Finance Document to "another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets".

If you would like further advice in relation to the issues discussed above please contact Robin Henry
E robin.henry@simmons-simmons.com
T +44 (0)20 7825 4943.

Simmons & Simmons

Keeping special purpose vehicles (SPVs) out of the UK tax net: some lessons learned from Wood v Holden

The recent case of Wood and another v Holden [2006] EWCA Civ 26, in which H M Revenue and Customs (HMRC) challenged (initially successfully but ultimately unsuccessfully) the use of an offshore SPV as part of a tax scheme provides a good opportunity to take stock of the practical measures which should be taken when using offshore SPVs in structured finance transactions to ensure that they remain offshore.

Whilst the taxpayers in Wood v Holden, who had incorporated a Dutch SPV in order to avoid UK capital gains on a sale of their company, eventually won their case before both the High Court and Court of Appeal, the HMRC challenge to the tax residence of the SPV was unexpected.It came with little warning given the relatively unlitigated history of offshore SPV residence. However, rather than relying on the outcome of Wood v Holden to take a more relaxed approach towards SPV management, particularly given the High Court's comment that SPVs might not require much "positive outward activity", those using offshore structures should rather be guided by the factors that this case demonstrates. Moreover, whether HMRC will seek leave to appeal to the House of Lords is as yet unknown.

It is firmly established that incorporation of a company outside the UK will not prevent UK residence if the central control and management of the company actually abides in the UK (De Beers Consolidated Mines v Howe [1906] AC 455). Though the SPV need not carry out many transactions to maintain non-UK residence, those which it does carry out must be done at the direction of and with the instruction of its board, acting independently. It is also crucial that there is sufficient evidence that the true mind of the company is the board, meeting outside the UK, which should comprise directors who are independent, qualified and in possession of suitable experience in order to demonstrate that they fully appreciate the decisions they make and have exercised independent judgment. Despite the exertion of influence from, for example, a parent company in the UK, or advice from a UK bank and its advisers, the structure's residence will be less prone to challenge if it can be shown that the directors' functions are not usurped. The taxpayers' success in Wood v Holden hinged on the fact that the directors of the SPV themselves, meeting in the Netherlands, and no other had made or directed the management decisions.

Incorporation of the SPV and consideration by it of the transaction in advance of the transaction or term sheet being finalised may help to demonstrate that the decision to enter into the transaction was made by the independent directors. Although it was commented in Wood v Holden that "a management decision does not cease to be a management decision because it might have been taken on fuller information" it is important that an SPV's board are given at least enough information to be consistent with the making of an independent decision. An SPV's parent or the bank which established it may advise the SPV but should not make decisions on its behalf. Similarly, any professional advisers should act pursuant to a carefully considered engagement letter which is clear that the instruction is for advice only, a feature of Wood v Holden that was helpful.

Finally, it is important that a suitable "paper trail" is established so that the independent decisions of an SPV can be demonstrated later, if needed.

Following these best practice principles (which are only a sample of those applicable) should help to avoid a dispute with HMRC in the form of another Wood v Holden.

If you would like further advice in relation to the issues discussed above please contact Mark Sheiham or Aron Joy of the tax department:

T +44 (0)20 7825 4146/3928
E mark.sheiham@simmons-simmons.com
E aron.joy@simmons-simmons.com