Co-Mingling Fund

Structure Note

This Structure Note has been prepared by Ashurst LLP based on laws, regulations and administrative and judicial interpretation as at 14 November 2013.

This Structure Note illustrates a possible structure for future co-mingling funds in the United Kingdom which are focused on achieving positive social impact and which intend to raise capital both from investors focused on social impact and also from investors focused on financial return. It is based on certain restrictions and assumptions provided to Ashurst LLP.

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14 November 2013

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1. **BACKGROUND**

1.1 This note describes a possible structure for a theoretical fund (the **"Fund"**) that would subscribe for debt, equity and debt/equity hybrid investments (**"Investments"**) in ventures that intend to achieve a positive social impact through their activities and which would commit to report to the Fund on such impact. This note is provided for information only and is not intended to illustrate the structure for any particular fund. It is intended to be read alongside the summary of terms dated on or around the date of this note which sets out the key commercial that could be used for the Fund (the **"Summary of Terms"**).

1.2 The structure for the Fund is set out in the diagram at schedule 1.

1.3 The Fund would be likely to have two types of investors (together, the **"Investors"**):

(a) Finance first investors focused on achieving a commercial risk adjusted return and who may not accept lower returns or greater risk in order to deliver social change; and

(b) Impact first investors focused on achieving social change who are prepared to accept lower returns and/or greater risk in order to deliver social change.

Investors in either class may be, among other things, public entities (such as local authorities or EU funds), corporates, charities or high net worth individuals or trusts established by such individuals.

1.4 To make the Fund as attractive as possible to finance first investors, the Fund would have "A" and "B" interests with different economic entitlements as described below. While it would be anticipated that finance first investors would subscribe primarily for A interests and that impact first investors would subscribe primarily for B interests, it would be possible for an Investor to subscribe for any combination of A and B interests (and therefore to have a blended economic exposure to the Fund).

1.5 The economic relationship between the holders of A and B interests would be established by the cash distribution waterfall set out in the Fund documentation as summarised in schedule 2. Note that while the basic principle of this waterfall is that holders of B interests would assume a "first loss" position in relation to capital returns (i.e. their capital would be returned to them only after the holders of A interests had received back an amount equal to all of their invested capital), this treatment would not apply to any income profits or capital gains of the Fund, which would always be distributed between the holders of A and B interests on a pro rata basis. This would avoid distorting the proportion of taxable returns received by the two classes of Investors, which might otherwise lead to disproportionate taxation of one class or the other. However it should also be noted that in the event that an investment was written off (and B Investors would not, therefore, receive back that portion of invested capital) there would be no adjustment of the ratio in which income profits or capital gains would be shared: i.e., a write off would result in reduced returns for holders of B interests even where the Fund is profitable overall.

1.6 It should be noted that there would need to be a specified minimum participation of B Investors (who would assume the "first loss" position) in order to define the extent of the first loss protection from an A Investor's perspective.

1.7 It is assumed that the Fund would be managed by an investment manager based in the UK (the **"Manager"**).

1.8 This note summarises a potential structure for the Fund and the associated key tax and commercial issues. The note also includes a high level summary of certain key regulatory issues but does not address the regulatory position of the Fund or the Manager in any detail.

2. ASSUMPTIONS

2.1 The potential structure for the Fund has been based on the assumption that:

(a) The Fund would make debt, equity and debt/equity hybrid investments in ventures which are tax resident and operated in the UK. The debt investments would typically be in the form of loan facilities (which may include loans to underwrite a portfolio venture's exposure in the event it did not obtain grant funding from elsewhere);

(b) The Fund would be marketed to the UK-based Investors of the sort set out in paragraph 1.3 above, but its Investors may also include international investors or UK-based investors investing through non-UK entities;

(c) The Fund would be sterling denominated;

(d) The Fund would not seek to enhance its returns by borrowing from third parties;

(e) The Manager would be paid a fee by the Fund for managing the business of the Fund;

(f) Neither the Manager nor its employees would be Investors in the Fund; and

(g) No carried interest would be paid to the Manager or its executives.

3. OUTLINE OF FUND STRUCTURE

3.1 The Fund would consist of one English limited partnership (the **"Partnership"**). Each Investor would participate as a limited partner in the Partnership. Additional feeder vehicles could be introduced if necessary to accommodate the needs of particular Investors.

3.2 English limited partnerships are versatile vehicles which are well understood and recognised by a wide range of investors. They can have flexible profit sharing arrangements to accommodate the different entitlements of the holders of the A and B interests (as set out in schedule 2). These entitlements would be documented in the agreement governing the Partnership.

3.3 Some funds include multiple parallel partnerships to accommodate particular investor requirements (e.g. where the tax treatment of investors in their home jurisdictions means they have different needs). As it is proposed that Fund receipts may be allocated either to holders of A interests or to holders of B interests at different stages in the Fund's distribution waterfall, it would not be practicable to use parallel partnerships unless the proportion of A interests and B interests was exactly the same in each partnership (otherwise the economic result for Investors could be different depending on which partnership they participate in, which would not be acceptable). While it would be possible to ensure that the proportions were the same at each closing of the Fund, there would always be a possibility that the proportions would vary later in the life of the Fund as a result, for example, of a defaulting investor. For that reason it is proposed that the Fund would consist only of the single Partnership and that no parallel partnerships would be used. In practice we would not expect that to present significant problems particularly where all Investors are based in the UK or where feeder vehicles are used.

3.4 The general partner of the Partnership would be a company incorporated in England and Wales (the **"General Partner"**) which would be a wholly owned subsidiary of the Manager.

3.5 The General Partner would be entitled to manage the Partnership and would receive a priority profit share for doing so. However the General Partner would appoint the Manager to provide management services to the Partnership in its place and would pay the Manager a management fee for the provision of those services. That fee would be funded out of the priority profit share paid to the General Partner.

3.6 The Partnership would be able to hold both debt and equity investments directly, but would also have the flexibility to use subsidiary investment holding structures if appropriate. However no specific structure is described in this note which is therefore written on the basis that, in particular, the Partnership would not use any structure designed to mitigate withholding taxes on interest (see 4.1 below).

3.7 The Fund's terms would be typical of private equity funds, including in particular:

(a) The Fund would have a fixed life of ten years, subject to extension or early termination in certain circumstances;

(b) The Fund would have an initial five year period during which new Investments may be made, again subject to extension and early termination provisions. After that period no Investments would be able to be made other than those that were previously contractually committed to or under negotiation (etc), or follow-on investments in existing portfolio ventures (subject to certain restrictions);

(c) Investors' committed capital would be drawn down by the Manager on an 'as needed' basis, and the proceeds from Investments would generally be distributed to Investors as and when they become available for distribution; and

(d) There would be no ability for Investors to redeem their interests, and the transfer of interests by Investors would only be possible with the consent of the Manager.

3.8 While the Summary of Terms illustrates a set of possible terms in more detail, the terms for any specific fund would need to be tailored to the particular circumstances of that fund. For example, if that fund was to have a substantial participation of charitable Investors then further consideration would have to be given as how those investors could be confident that their investments would be consistent with their charitable purposes.

4. TAX ANALYSIS FOR THE FUND

4.1 Withholding Tax on Payments by Portfolio Ventures to the Fund

The UK does not generally impose withholding tax on dividends or capital gains. However, the UK does generally impose withholding tax at 20 per cent on interest payments by UK companies (including bodies corporate, unincorporated associations and partnerships with company members). It is expected that a significant number of debt investments will fall into these categories.

The withholding tax exemptions that are most often used apply for:

(i) Interest paid by a UK company to a partnership with partners that are all companies resident in the UK and certain other specified classes of person. On the basis that the Fund's Investors may well include UK individuals this exemption would not be available;

(ii) Interest paid on quoted Eurobonds, which would require the loans to be listed on a recognised stock exchange, such as the Channel Islands Stock Exchange. As it is anticipated that the debt investments of the Fund would not generally be structured using quoted Eurobonds, this exemption would not apply;

(iii) Interest that is treated as a distribution for tax purposes, including certain cases where the amount of interest depends on the borrower's profits. This exemption would not apply to loans with a simple interest rate, which we understand would typically be the case for the Fund's Investments; and

(iv) Where amounts are lent at a discount, the element of discount should not generally attract withholding. It may be possible, with careful drafting of the loan terms, to use this exemption in cases where no payments are due till the end of the term of the loan. However we understand that the Fund's Investments would typically include a cash-pay coupon.

In short, many, or perhaps most, of the Fund's debt Investments would be likely to suffer withholding tax at 20 per cent. on interest paid to the Partnership. UK taxpaying Investors should be entitled to credit for that withholding tax when calculating their tax liability for the relevant tax year. For example, an additional rate individual taxpayer is subject to tax on interest income at 45 per cent. but would be entitled to credit for the 20 per cent. tax withheld so that the outstanding tax liability is 25 per cent. of the gross interest payment. Furthermore, UK tax exempt investors should be entitled to reclaim the withheld tax as an overpayment since they should not bear tax on their exempt income (and may be able to do so relatively promptly in the case of charities). Accordingly, the cost of tax being withheld by portfolio ventures on interest payments attributable to UK Investors should represent a timing/administrative cost rather than a reduction in Investor's returns.

However the position for any non-UK Investors (including for example any UK individuals who invest through a non-UK trust or other investment vehicle) will depend on the tax rules in their jurisdiction of residence and any applicable double tax treaty. While it is generally expected that any Investors subject to foreign taxes would be entitled to credit in their own jurisdiction for the UK tax withheld and any Investors exempt from foreign taxes may be entitled to claim repayment of the tax withheld under a suitable tax treaty, any Investors subject to neither UK nor foreign taxes (including trusts established by UK individuals) would be unable to claim repayment of the tax withheld. The Fund may therefore be unattractive for any such non-UK Investors. Borrowers may also be concerned by the administrative inconvenience of having to withhold tax on interest payments though the Fund could potentially help with some standard form documentation and guidance for borrowers.

4.2 Taxation of the Partnership

The Partnership should be treated as transparent for UK tax purposes, with the result that Investors, rather than the Partnership itself, would be taxed on its profits.

Non-UK Investors would be subject to UK tax to the extent that the Partnership carries on a trade for UK tax purposes (that tax being collected from the General Partner). However, the Partnership should not be carrying on a trade provided that:

(a) it generally intended to hold its Investments for at least three years; and

(b) it did not acquire Investments with a view to making a short term profit (by, for example, selling the Investment to an already-identified third party).

We assume that conditions (a) and (b) would be complied with.

The Partnership might also be treated as carrying on a trade if it were to receive fees such as, for example, transaction arrangement fees. This should be avoided by paying any such fees to the Manager instead of to the Partnership, with the General Partner's profit share being reduced by a corresponding amount so that the Fund still enjoys the benefit of the fees but without generating trading profits.

4.3 Withholding Tax on Payments by the Fund to the Investors

Subject to the requirements of the EU Savings Directive (as applied by the UK), no UK withholding taxes or direct taxes should apply to distributions by the Partnership. The agreement governing the Partnership would include language designed to ensure that Investors comply with any EU Savings Directive requirements so that no withholding should be required under that directive. It would also include language designed to ensure that the provisions of the UK implementation of the US Foreign Account Tax Compliance Act would be complied with in order to minimise the possibility of withholding taxes arising under those provisions.

4.4 Summary of UK Taxation Position

In essence, assuming the above points would all be complied with and that the distribution waterfall adjusted only the priority of capital returns (but not of investment profits) to investors, the result should be that:

(a) UK taxpaying investors should broadly pay tax on a very similar basis as if they had invested directly in their proportion of the underlying Investments (subject in certain cases to the timing cost of the withholding discussed above);

(b) Non-UK taxpaying investors should only suffer UK tax to the extent that there was any UK withholding tax on Investment interest that could not be recovered.

Finally, it is worth noting that effective tax relief would be unlikely to be available to UK taxpaying investors to the extent particular investments were written off by the Fund. Thus, it would be possible for a UK taxpaying investor (whether a holder of A interests or B interests) to subscribe £100 for an interest in the Fund, receive back £10 of interest but receive, say, only £90 of principal and yet nonetheless have to pay tax on the £10 of interest.

5. UK TAX ISSUES FOR THE MANAGER

5.1 Fees Payable to the Manager

The management fees paid to the Manager would be reflected in its taxable profits after taking into account all the normal course deductions (i.e. for salary, interest costs etc).

There should be no VAT on the fees paid by the General Partner to the Manager provided that they are members of the same VAT group.

5.2 VAT Recovery Position of the Manger

Because the Fund would be carrying on exempt business, the Manager would generally be unable to recover the VAT on its costs which would be directly attributable to the Fund. However, on the basis that the Fund would bear its own establishment costs (if any) and transaction costs, these costs should not be substantial.

The Manager may also be unable to recover the VAT on any of its costs which are not directly attributable to the Fund. However, this will depend on the Manager's other activities.

6. REGULATORY ANALYSIS FOR THE FUND

6.1 Regulatory Position for the Manager

On the basis that the Fund would be structured as an English limited partnership which is managed onshore, then the normal position is that the Manager would need to be authorised by the Financial Conduct Authority.

Assuming the Manager is managing funds with aggregate assets of either (1) less than €100m or (2) less than €500m where the funds are not leveraged and investors have no redemption rights for the first five years, the Manager would fall under the *de minimis* exemption under the Alternative Investment Fund Managers Directive (the **"AIFMD"**).

On that basis, given that the Fund's investments do not primarily relate to land, and assuming that the Manager would not be registered under the European Social Entrepreneurship Fund regulations or the European Venture Capital Fund regulations (and would not otherwise qualify as a "small registered AIFM"), the Manager would be a "small authorised AIFM" and would need FCA authorisation for the activity of "Managing an AIF".

6.2 The Partnership

The Partnership would be established under the Limited Partnerships Act 1907 and would be unregulated.

6.3 Marketing of Fund Interests

On the basis that the Manager is a small authorised AIFM, it would need to rely on private placement exemptions to market the Fund to investors in Europe (as small AIFMs cannot use the AIFMD passporting procedure). The manager would therefore need to comply with local private placement restrictions on marketing the Fund in the relevant European jurisdictions.

If the Manager needed the ability to market the Fund throughout Europe on a passporting basis then it could opt in to the full requirements of AIFMD and become a full scope UK AIFM, although that would result in greater operational compliance requirements for the Manager.

In any event there may be additional restrictions on marketing to retail (ie non-professional) investors. For example, in the UK, units in an unregulated collective investment scheme may only be marketed to certain categories of investors. In particular, there will be a new regime that applies in the UK from 1 January 2014 which will effectively ban the marketing of units in unregulated funds (and other "non-mainstream pooled investments") to "ordinary retail" investors. There will be exceptions, and the detail depends on whether the person marketing the fund is authorised by the FCA or not. The exceptions are more generous for those that are not authorised, but on the basis that the Manager is FCA authorised, then it will be restricted to marketing to investors that are both high net worth <u>and</u> sophisticated. There are some other exceptions (e.g. for certain one-off communications) but these are likely to be of limited use.

Generally speaking, in many jurisdictions outside Europe the Manager may be restricted to marketing to sophisticated or institutional investors.

Separate advice will be required on a case by case basis for these issues.

6.4 Filing of Partnership accounts

Under certain circumstances, the general partner of a "qualifying partnership" will be obliged to file accounts for an English limited partnership at Companies House. Following proposed changes to the accounts regulations, the Partnership would be likely to be a "qualifying partnership" and as such the Partnership accounts may need to be made public. This should be discussed further with the Fund's auditors.

6.5 Regulation of the Lending Activities in the Investee Company Jurisdiction

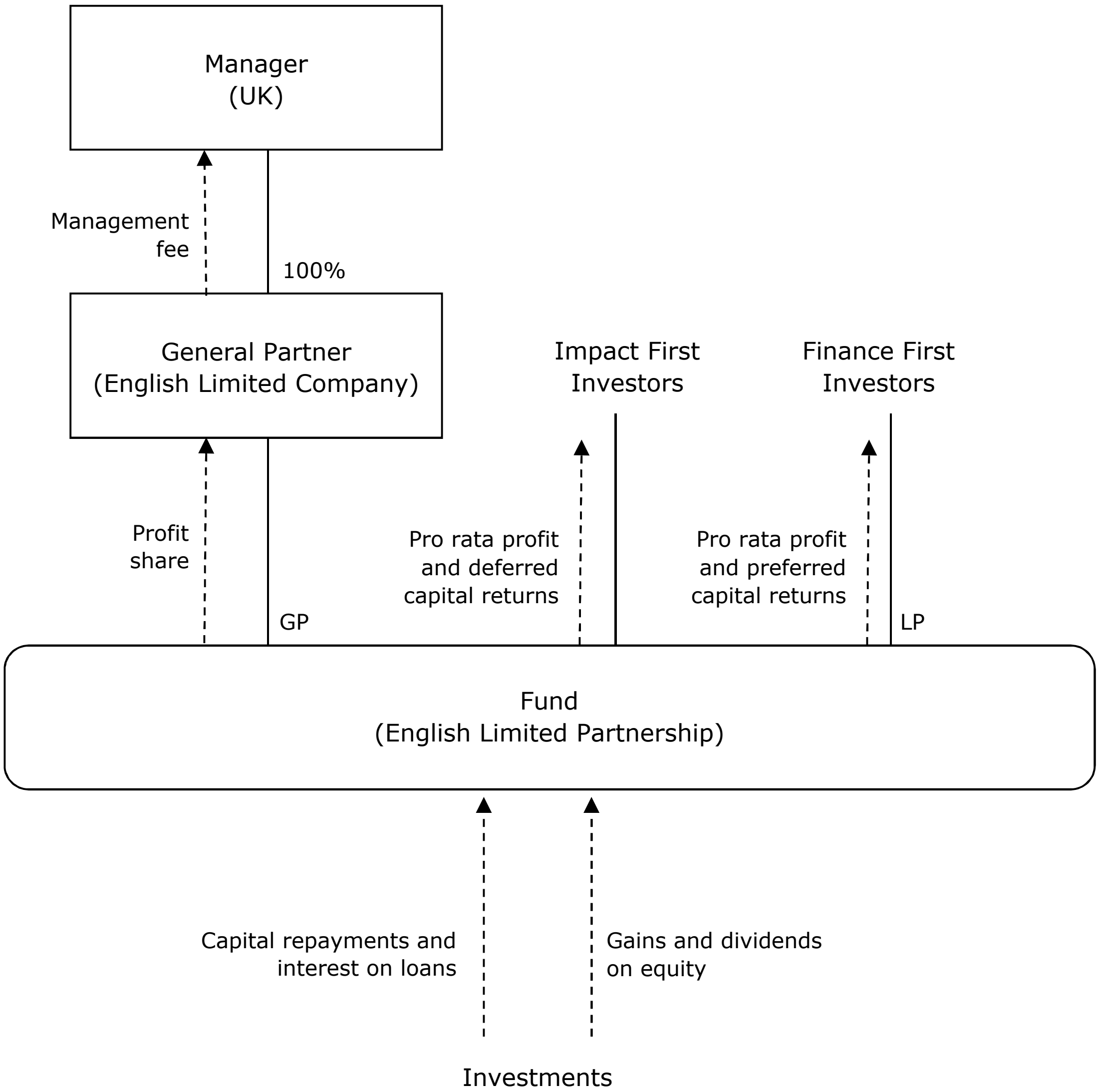
As the Fund would be investing exclusively into UK companies, there should be no restrictions imposed by banking monopoly rules (which in the UK apply only in retail situations).

6.6 Risk Factors

The Fund would need to issue a private placement memorandum to prospective Investors detailing among other things the risk factors that are associated with any investment in the Fund (including for example the risk of the loss of some or all invested capital, the deferred nature of the capital returns for the holders of B interests, the risk that Investors may in some circumstances be taxed on amounts that exceed their economic profit in the Fund as described at 4.4 above, etc). However assuming the Manager is not a full scope FCA authorised UK AIFM (ie it is either a "small authorised" or "small registered" AIFM) it will not need to comply with the disclosure requirements set out at article 23 in the AIFMD.

SCHEDULE 1

Structure Diagram



SCHEDULE 2

Distribution Waterfall

After deducting or providing for such liabilities as the Manager may determine, such assets of the Fund as are available for distribution by the Partnership would be distributed as between the Investors pro rata to their respective shares of the relevant Partnership assets but subject to the following order of priority:

(a) to the General Partner in satisfaction of the General Partner's Profit Share in respect of each such Investor (to the extent not already satisfied by previous distributions); and then

(b) in relation to such Partnership assets which represent income or capital profits, to the Investors holding A interests and B interests; or

(c) in relation to such Partnership assets which represent capital returns, in the following order of priority:

 (i) to the Investors holding A interests in an amount equal to their drawn down Commitments which then remain outstanding after taking into account all distributions then made to those Investors; and then

 (ii) to the Investors holding B interests in an amount equal to their drawn down Commitments which would remain outstanding after taking into account all distributions then made to those Investors, but excluding their share of any distributions made pursuant to (b) above where such distributions were not taken into account pursuant to (i) above; and then

 (iii) to the Investors holding A interests and B interests.