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Client Alert Commentary

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New Spanish Regulation for Venture Capital and Private Equity Entities

Changes harmonize Spanish regulations with existing EU regulations and increase the scope of acceptable investment activities for closed-ended investment entities.

Introduction

On 12 November 2014 the Spanish Parliament enacted new law 22/2014, regulating venture capital and private equity entities, other closed-ended investment entities and investment managers for closed-ended investment entities (Law 22/2014) in order to harmonize the Spanish regulation with Directive 2011/61/EU, of the European Parliament and of the Council of 8 June 2011, on alternative investments fund managers (AIFMD).

Law 22/2014 totally derogates former law 25/2005, which until now regulated Spanish venture capital and private equity (Law 25/2005) and establishes a new legal framework for venture capital and investment managers and other closed-ended investment entities.

In addition to implementing the AIFMD, Law 22/2014 introduces important measures to promote fundraising among investors and provide alternatives to bank financing to a larger number of companies, including small and medium-size companies — which in the last years have experienced problems of access to credit in the wake of the economic crisis.

Closed-ended investment entities

Pursuant to Law 22/2014, closed-ended investment entities are distinguished from open-ended entities by the fact that (i) the divestment will take place simultaneously with respect to all of the investors; and (ii) each investor will be remunerated on an individualized basis, in accordance with the regulations and by-laws applicable to each class of shares.

In this sense, venture capital and private equity entities are deemed to be closed-ended investment entities for the purposes of Law 22/2014. These entities may either be incorporated as companies (*sociedades de capital riesgo*) or funds (*fondos de capital riesgo*). Both venture capital and private equity companies and funds will be subject to (i) a general common regime set out in Law 22/2014 and applicable to both types of entities; and (ii) certain special rules distinctly applicable to companies and funds.

Scope of Law 22/2014

Law 22/2014 applies both to private equity and venture capital entities, other closed-ended investment entities and managers of closed-ended investment entities, including, in particular, those entities with a registered office in Spain or funds incorporated in Spain.

Additionally, certain provisions of Law 22/2014 apply to the commercialization in Spain of closed-ended venture capital, private equity and other investment entities incorporated in other European Member States and in third-countries.

Open-ended investment entities are excluded from the scope of Law 22/2014 and will continue to be subject to Law 35/2003, of 4 November, regulating collective investment institutions. In addition, certain other investment entities such as pension funds, securitization funds and listed investment companies on the property market (*socimis*) are excluded from the scope of Law 22/2014 and subject to special regulations.

Simplified incorporation process

Law 22/2014 has simplified the process for the incorporation of venture capital and private equity entities in Spain. In this sense, the prior authorization of the Spanish Securities Exchange Commission (CNMV) is no longer required and incorporation will be validly completed upon registration with the CNMV. The prior authorization of the CNMV is, however, still applicable for the valid incorporation of venture capital and private equity entity managers in Spain.

Distinction between "ordinary entities" and "simplified entities" no longer applies

Pursuant to Law 25/2005, venture capital and private equity entities were classified in two categories: "ordinary scheme entities" (*entidades de régimen común*) and "simplified scheme entities" (*entidades de régimen simplificado*). In broad terms, the latter were subject to less restraining regulations and exclusively reserved to professional investors.

Law 22/2014 has ruled out these two categories and forthwith a common legal regime will apply to all closed-ended of investment entities. In practice, this implies that certain legal benefits which simplified scheme entities previously enjoyed are no longer in force, including, for instance, reduced investment diversification requirements. On the other hand, some provisions that were formerly only applicable to simplified scheme entities (*e.g.*, the right to issue different classes of shares or interests or the obligation to issue an offering memorandum for commercialization purposes) now apply to all closed-ended investment entities.

Amendments to the basic regulation of closed-ended investment entities

Law 22/2014 amends some of the basic provisions applicable to venture capital and private equity entities, including the following:

New core activities

The core activities of venture capital and private equity entities have been extended and these entities are now allowed to invest in other venture capital and private equity entities without limitation (pursuant to former Law 25/2005 these investments were limited to twenty percent (20%) of the total net asset value).

Amendments to the capital requirements of closed-ended investment entities upon incorporation

Pursuant to former Law 25/2005, in-kind contributions upon incorporation were only allowed with respect to venture capital and private equity companies, but not for venture capital and private equity funds. However, pursuant to Law 22/2014, in-kind contributions upon incorporation are now allowed with respect to venture capital and private equity funds, but not for venture capital and private equity companies.

New fiduciary regime applicable to managers

Each venture capital and private equity entity will have a single manager. Venture capital and private equity companies may be self-managed in case their government body decides not to outsource the management.

Pursuant to Law 22/2014, a new fiduciary regime will apply to closed-ended investment entity managers with respect to investors regarding the performance of their duties. This new regime comprises (i) loyalty duties; (ii) duties regarding conflicts of interest; (iii) new remuneration systems and controls; and (iv) a liability regime.

Investment restrictions

Law 22/2014 continues to establish a mandatory restricted investment ratio (*coeficiente obligatorio de inversión*), whereby venture capital and private equity entities are obliged to have invested, by the end of each fiscal year, at least sixty percent (60%) of their total accountable net asset value in:

- Shares or equivalent securities of companies in their core business
- Participative loans directly related to business performance and granted to companies in their core business
- Other participative loans not related to business performance and granted to companies in their core business, up to thirty percent (30%) of their total accountable net asset value to other participative loans
- Shares of other private equity and venture capital entities.

Amongst others, the restricted investment ratio described above will not apply in the following cases:

- During the first three (3) years after registration of the private equity or venture capital entity with the CNMV
- During the twenty four (24) month period following a divestment that results in a breach of the restricted investment ratio, provided there was no prior breach of the restricted investment ratio
- During the three (3) year period following the share capital increase of the private equity or venture capital entity via contribution, provided there was no prior breach of the restricted investment ratio

Subject to compliance with the so-called mandatory investment diversification ratio (*coeficiente de diversificación*) (as described below), the restricted investment ratio will not apply in case private equity and venture capital entities invest all of their accountable net asset value in other domestic or foreign private equity or venture capital entities. For these purposes, the only investments in foreign entities that will be deemed valid are those that are (or, as the case may be, have their managers) (i) registered in any of the European Union Member States; or (ii) registered in third-countries that are not listed as a Non-

Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing and that have executed a double taxation or tax information exchange agreement with Spain.

The remaining forty percent (40%) of the total accountable net asset value constitutes the unrestricted investment ratio (*coeficiente de libre disposición*). Private equity and venture capital entities may freely invest the funds subject to the unrestricted investment ratio in traded fixed income securities, shares of companies outside their core business, cash, participative loans and financing of investee companies in their core business.

Venture capital and private equity entities are subject to a further general and mandatory investment diversification requirement, pursuant to which:

- No more than twenty five percent (25%) of their total accountable net asset value may be invested in the same company
- No more than thirty five percent (35%) of their total accountable net asset value may be invested in the same group of companies
- Up to twenty five percent (25%) of their total accountable net asset value may be invested in affiliate companies (or, as the case may be, in affiliates of their manager), subject to certain formal requirements

SMEs venture capital and private equity entities (*entidades de capital riesgo-Pyme*)

With a view to promoting investment in the early stages of the development of companies and offering small and medium enterprises (SMEs) an alternative to bank financing, Law 22/2014 regulates a new type of investment entity known as SMEs venture capital and private equity entity (*entidades de capital riesgo-Pyme*).

SMEs venture capital and private equity entities are obliged to have invested, by the end of each fiscal year, at least seventy five percent (75%) of their total accountable net asset value by way of equity acquisitions, participative loans, hybrid financial instruments, debt instruments and shares of other SMEs venture capital and private equity entities.

For the purposes of Law 22/2014, SMEs venture capital and private equity entities will need to invest in companies that meet the following requirements: (i) unlisted companies; (ii) less than 250 employees; (iii) annual asset value under €43M or less than €50M business volume; (iv) not an investment entity; (v) not a financial or real estate entity; (vi) incorporated in a European Union Member State or registered in third-countries that are: not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing; and that have executed a double taxation or tax information exchange agreement with Spain.

SMEs venture capital and private equity entities are subject to a further mandatory investment diversification requirement, pursuant to which no more than forty percent (40%) of their total accountable net asset value may be invested in the same company or in the same group of companies.

Tax implications

With regard to the tax framework of the venture capital entities, the new Law does not change their specific tax regime (which remains governed by the Corporate Income Tax legislation). A new Corporate Income Tax Law is undergoing legislative approval (it has been recently approved by the Spanish Senate and should enter into force — after Congress gives final approval — as from 1 January 2015), but we do not expect that the tax regime of the venture capital entities under the new Corporate Income Tax law will change significantly.

Therefore, the main features of such tax regime will likely remain unaltered (*i.e.*, ninety nine percent (99%) capital gains exemption on divestments in target companies or other venture capital entities between the 2nd and the 15th year of the investment; availability of a participation exemption on dividends, regardless of the stake held and holding period of the investment; exemption on the dividends and capital gains realized by Spanish corporate investors and non-resident investors in the venture capital entity).

Regardless of the fact that the tax regime features will remain the same, we expect further reforms will be enacted under the New Corporate Income Tax Law, and those reforms could have a broader impact on venture capital entities´ business models. For instance, the scope of the Spanish participation exemption regime on dividends and capital gains shall be widened, and shall cover not only qualifying shareholdings in foreign subsidiaries, but also qualifying shareholdings in domestic ones (*i.e.* shareholdings of at least five per cent (5%) or having an acquisition cost of more than €20M). In relation to capital gains, such a development improves the current taxation of divestments in Spanish subsidiaries. In addition, the new "anti-hybrid loan" rules shall change the treatment of profit participating loans in the context of intra-group financing (*i.e.*, interest accruing thereunder shall be non-deductible at the level of the borrower, but may be treated as a tax-exempt dividend at the shareholder-lender level), and the new rules further limiting the deductibility of interest in leveraged buy-out (LBO) deals, are also bound to have an impact on the structuring of Spanish deals.

Conclusion

The new regulation aims to promote companies' direct financing though more flexible formulas and to reduce the banking finance dependency of the Spanish companies, in particular for the SMEs (*pymes*). This flexible framework will allow closed-ended investment entities to expand their activities into investments in other investment entities, but, in exchange, they will be subject to additional requirements on certain investment activities imposed by the new regulation.

Although this new regulation is generally welcome as a way to solve the access to credit for the Spanish companies and to promote the investment in Spain, we look forward to seeing if it will finally achieve the proposed goals.

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