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The International Dispatch

Akin Gump
Strauss Hauer & Feld LLP

IN THIS EDITION

Welcome to *The International Dispatch*, where, in this edition, we bring clients and friends of the firm the news of, and developments in, the global fund management industry during the last six months. In particular, we look at some of the issues facing private equity and real estate funds around the world and also look at recent EU developments on short selling.

Akin Gump is one of the few law firms to make its investment funds and private equity practice a core part of an international strategy, representing not only clients working in the established financial centers, but also those focused on emerging global economies.

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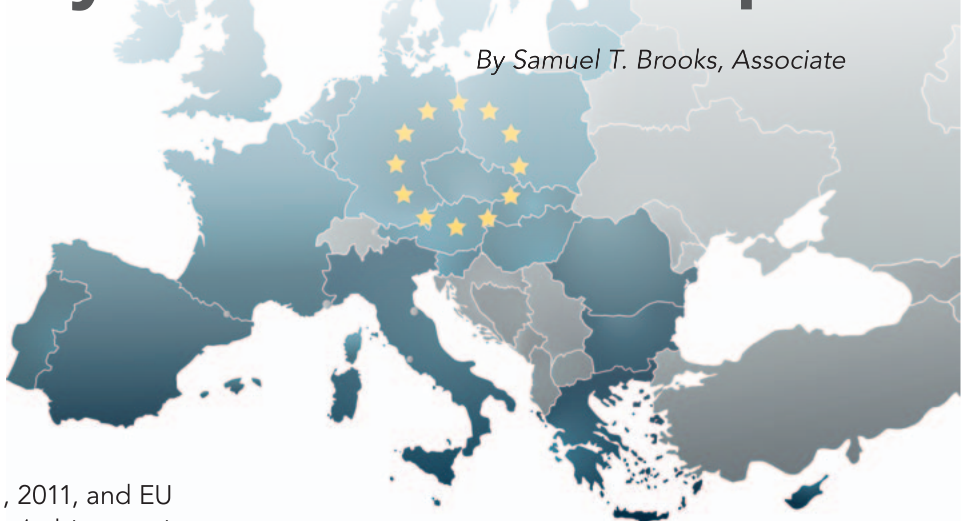
The AIFM Directive and Private Equity Funds in Europe

By Samuel T. Brooks, Associate



On July 1, 2011, Directive 2011/61/EU—the Alternative Investment Fund Managers Directive (the "Directive")—was published in the Official Journal of the European Union, bringing the lengthy legislative process around this much-debated new regulatory regime into its final stages. The Directive came into force on July 21, 2011, and EU member states now have up to two years (subject to time extensions in respect of certain sections) to transpose the Directive into national law—so alternative investment fund managers (as defined in the Directive) can expect to be subject to most of its provisions by the second quarter of 2013.

The aspects of the Directive with the broadest potential impact, such as "third-country" funds, depositary requirements and the marketing "passport" have already been discussed and dissected at length in a number of publications and regulatory submissions, and most industry participants will, by now, be aware of them. This article will not seek to reexamine these issues, but will, instead, focus on specific provisions of the Directive that are primarily, or, in some cases, solely, of interest to private equity fund managers. That the private equity sector is covered by the Directive at all has been controversial, as the principal purported justification for the Directive was to manage the systemic risk supposedly created by highly leveraged investment funds, particularly those with complex networks of derivative investments. The provisions of the Directive examined in this article suggest that a political desire to control certain actions of the private equity industry, unrelated to the financial crisis or any sort of systemic risk, may also have been a factor. These provisions are the "asset stripping" rules, notification and disclosure provisions, and annual reporting requirements.

Since the extension of the Directive to the private equity sector is contentious, an attractive alternative to compliance with the Directive may simply be to remain out of the scope. The Directive applies, to a greater or lesser extent, to EU-based managers, non-EU based managers that manage EU-based funds and any manager or fund that is marketed in the EU, irrespective of domicile. Accordingly, a U.S.-based general partner managing a Delaware or Cayman Islands-based private equity fund would not fall within the scope of the Directive, unless the fund were marketed in the European Union, in which case certain limited provisions would apply. Should non-EU general partners choose this route, the challenge will be to attract funding from European investors without thereby coming into scope—perhaps by structuring investments through financial instruments that are not covered by the Directive.

Asset Stripping

The "asset stripping" rules are one of the most overtly ideological aspects of the Directive. These rules are intended to prevent private equity funds from purchasing a business with the intention of recapitalizing it in order to distribute assets to the investor. Whether or not this is a good thing is debatable, but it is conspicuous that the asset stripping rules apply only to business purchases made by alternative investment funds, not by any other investors.

The rules apply where an alternative investment fund, individually or jointly and directly or indirectly, acquires control (i.e., over 50 percent of the voting rights) of a non-listed company domiciled in the European Union (subject to exceptions for certain small and medium-sized enterprises) (a "Non-Listed Company"). In such circumstances, the alternative investment fund manager must, for a period of 24 months following acquisition of control—

- not facilitate, support or instruct;
- not exercise its vote at any meetings of the governing bodies of the target in favor of; and
- in any event, use its best efforts to prevent

any distribution, dividend, capital reduction, share redemption and/or acquisition of its own shares (a "Distribution") by the target where—

- on the closing date of the last financial year, the target's net assets are, or, following the Distribution (including, in the case of an acquisition by the target of its own shares, as a result of such acquisition), would become, lower than the target's subscribed and called capital, plus any reserves that may not legally be distributed; or
- the amount of the Distribution would exceed the amount of the target's profits at the end of its last financial year plus any profits brought forward and reserves available for distribution, less any losses brought forward and sums legally required to be placed in reserve.

These rules are certainly a strong deterrent to asset stripping by alternative investment funds, although not, as previously noted, by any other investors. However, certain other unintended consequences may also arise. For example, the acquisition of control of a Non-Listed Company by an alternative investment fund may prevent the target from reorganizing or refinancing itself for perfectly legitimate reasons or may restrain the target from divesting assets and making distributions when market conditions are optimal.

Significantly, the asset stripping rules do not cover repayments by a target of shareholder loans, so it is possible that Directive-compliant transfers of capital to a controlling private equity fund could still be structured—subject to any relevant restrictions on permissible debt levels for the target. Nevertheless, the asset stripping rules may have the effect of making acquisitions of Non-Listed Companies substantially less commercially attractive for EU private equity funds.

Notification and Disclosure Provisions

The Directive sets out a number of notification requirements in connection with acquisitions and disposals of shares of Non-Listed Companies.

As soon as possible (and within no more than 10 working days), the relevant alternative investment fund manager must notify its home regulatory authority where the holding of shares in a Non-Listed Company by an alternative investment fund reaches, exceeds or falls below thresholds of 10 percent, 20 percent, 30 percent, 50 percent and 75 percent.

Where an alternative investment fund acquires control of a Non-Listed Company, the alternative investment fund manager must, as soon as possible (and no later than 10 working days) after the date of acquisition of control, notify the company's management, as well as the other shareholders and the alternative investment fund manager's home regulatory authority of such acquisition, stating the resulting situation in terms of voting rights and the date on which, and the conditions subject to which, control was acquired. In the notification to the company's management, the alternative investment fund manager must request that the board of directors inform the employees' representatives or, where there are none, the employees themselves of the acquisition, and it must use its best efforts to ensure that such persons are duly informed.

In addition to the general notification requirement, where an alternative investment fund acquires control of a Non-Listed Company, the alternative investment fund manager must make available to the company's management, as well as the other shareholders and the alternative investment fund manager's home regulatory authority: (i) the identity of the alternative investment fund manager (or managers, in the case of a joint acquisition of control), (ii) the policy for preventing and managing conflicts of interest between the alternative investment fund, its manager and the company and (iii) the policy for communication relating to the company as regards employees. It must also inform the company and other shareholders of its intentions with regard to the future business of the company and the likely repercussions on employment, including the conditions of employment. As for the notification of control, the alternative investment fund manager must request that the board of directors pass all of this information to the employees' representatives or, where there are none, the

employees themselves, and it must use its best efforts to ensure that such persons are duly informed.

Finally, the alternative investment fund manager must, where an alternative investment fund acquires control of a Non-Listed Company, provide its home regulatory authority and the investors in the relevant fund with information regarding the financing of the acquisition.

Annual Reporting Requirements

Where an alternative investment fund acquires control of a Non-Listed Company, either the company's annual report or the fund's annual report must include a fair review of the development of the company's business over the relevant period, providing an indication of any important events that have occurred since the end of the financial year, the company's likely future development and information concerning acquisitions by the company of its own shares. The alternative investment fund manager is responsible, if this information will not be included in the fund's annual report, for requesting and using its best efforts to ensure that the company's annual report contains this information. It must also request and use its best efforts to ensure that the information is provided to the employees' representatives (or, where there are none, the employees themselves) and make the information available to investors in the fund.

As with the asset stripping rules, it is unclear why a private equity fund acquiring control of a Non-Listed Company should attract notification, disclosure and reporting requirements, while any other investor acquiring control should not. Clearly, many business combinations purely between trading companies are undertaken to realize potential synergies and cost savings, and rationalizing employment is often a major factor in this. However, unlike the asset stripping rules, while the notification, disclosure and reporting requirements will result in greater costs for private equity funds within the scope of the Directive, they are at least only prescriptive, not prohibitive.

Other Relevant Issues

As noted above, the Directive contains a number of provisions that are not specifically aimed at private equity funds and their managing entities, but that will nevertheless be highly significant to the private equity industry. Two key examples of such provisions are the leverage and remuneration rules.

The leverage rules are left intentionally vague in the Directive, and it is expressly contemplated that the Level 2 implementation measures being undertaken by the European Securities and Markets Authority (ESMA) will provide more detailed regulations. At present, leverage is defined as including "any method" of increasing a fund's exposure, including "borrowing of cash or securities, or leverage embedded in derivative positions or by any other means." In principle, this seems sufficiently broad to include leverage at the level of portfolio companies held by private equity funds. By contrast, Recital 78 of the Directive states that "for private equity and venture capital funds… leverage that exists at the levels of a portfolio company is not intended to be included." However, the Directive leaves a gray area in relation to leverage employed by subsidiaries formed by private equity funds to invest in specific portfolio companies. Among other matters, how to define leverage was an issue raised by ESMA in its April 2011 discussion paper on the implementation measures. In response, the European Private Equity and Venture Capital Association has suggested that leverage created at the level of a subsidiary of a private equity fund should only be included in the definition of leverage for the purposes of the Directive where it increases the exposure of the fund—for example, where the fund has guaranteed the debt of the subsidiary entity. This would seem a sensible compromise position and in its July 2011 consultation paper, ESMA appeared to endorse it, suggesting that leverage at the level of a subsidiary entity should only be included in the calculation of a private equity fund's leverage if it has provided guarantees or security for the debt.

The remuneration rules in the Directive have been controversial. Many commentators have commented that they attempt to take rules developed primarily to deal with bonuses paid to employees at large financial institutions and apply them to remuneration received by the principals of private equity fund managers (and other alternative investment fund managers) in their capacity as owners, not employees, of these businesses. One particularly unhelpful provision for private equity fund managers, with investment teams frequently dedicated to operating just one of several funds under management, is that the Directive states "variable remuneration" should only be paid if justified by the financial performance of the alternative investment fund manager as a whole. It is difficult to see how this will be reconciled with, for example, deal-by-deal carried interest payments.

To AIFMD or not to AIFMD

Many of the provisions of the Directive relating to private equity funds are onerous, and some are clearly ideological. One option for unimpressed non-EU private equity fund managers may simply be to remain out of the scope of the Directive. In the first instance, "third-country" funds will remain able to market to European investors through the existing private placement regimes until at least 2018. Even if the private placement regimes are subsequently phased out, since the Directive only applies to the marketing of alternative investment funds (as defined in the Directive), it may be possible to avoid the need to be in scope by structuring private equity products for European investors by way of, for example, notes issued by an offshore company. Whether remaining out of scope will be a feasible option for private equity funds seeking to raise European capital will largely depend on market practice and on the question of whether European institutional investors accept that the Directive is simply too burdensome for an in-scope private equity fund manager to be commercially viable.

An interesting aside is that the European Commission recently published a consultation paper in relation to venture capital funds, in which it proposed either to exempt them entirely from the provisions of the Directive or, alternatively, to tailor a subsidiary system to deal with them within the framework of the Directive. The Commission's stated rationale for this is that venture capital is not the "focal point" of the Directive and that venture capital funds are not likely to pose either important systemic risk to the financial system or create specific investor protection concerns, since they are addressed to professional investors. Of course, these same descriptions could equally be applied to the private equity sector, and the consultation paper has, therefore, caused eyebrows to be raised among representatives of European private equity. It will be interesting to see what, if any, distinctions the Commission will draw, once industry comments have been submitted.

As the Level 2 implementation process continues and the secondary legislative regime surrounding the Directive takes shape, its likely impact on private equity funds and their managers should soon become evident. What is clear is that, irrespective of protestations that the private equity industry poses little or no systemic risk and that the provisions of the Directive are disproportionate, the Directive will constitute a substantial new regulatory framework for the private equity industry. Non-EU general partners and investment advisers, in particular, and the private equity industry, in general, will soon be faced with a choice as to whether being in scope brings more advantages than disadvantages.

New EU Short Selling Regulation Introduces Restrictions and Disclosure Requirements

Caught Short

By Graeme Bell, Counsel

Summary

On November 15, 2011, the European Parliament approved the final text of the Regulation on Short Selling and certain aspects of Credit Default Swaps (the "Regulation"). Subject to being formally approved by the EU Council in the coming weeks, the Regulation is to come into effect on November 1, 2012, and will introduce restrictions and disclosure requirements on persons short selling EU shares and sovereign bonds and prohibit naked or uncovered credit default swaps (CDSs) relating to EU sovereign debt.

Background

According to the European Commission, the Regulation comes in response to the fragmented reaction of member states of the European Union during the financial crisis and, more recently, in the context of market volatility in euro-denominated sovereign bonds, to the issues raised by short selling and credit default swaps.

The three main risks of short selling that the European Commission sought to address in the Regulation are: (i) transparency deficiencies, (ii) the risk of negative price spirals and (iii) settlement risk associated with naked short selling. The Regulation covers both short selling and CDSs because the latter can be used "to secure a position economically equivalent to a short position in the underlying bonds."

The final wording of the Regulation differs from that published on July 5, 2011, as it incorporates certain concessions to the European Parliament and member states with regard to the banning of uncovered sovereign CDSs.

Key Provisions of the Regulation

Disclosure of Short Positions

Shares

The Regulation introduces a requirement to make a private notification to member states' competent authorities of "net short positions" above 0.2 percent of the issued share capital of an issuer and further notifications at each further 0.1 percent increment, as well as public disclosure when such position crosses 0.5 percent and further public disclosures for each further 0.1 percent increment. These disclosures must include the identity of the person holding the net short position.

Sovereign Bonds

Notification relating to "net short positions" in sovereign bonds need only be made to regulators and will not be made to the public. The notification requirements relating to each member states' sovereign debt will be published by the European Securities Markets Authority (ESMA) on its Web site.

A net short position is calculated after netting off any long positions held. The definition of "net short position" for both shares and sovereign bonds includes any position arising through the use of derivatives, including CDSs.

Restrictions on Uncovered (Naked) Short Sales

Shares

Short sales of shares are restricted by the Regulation with the effect that the short seller must either have—

- borrowed the shares or have made alternative provisions resulting in a similar legal effect; or
- entered into an agreement to borrow the shares or have another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due; or
- entered into an arrangement with a third party under which that third party has confirmed that the share has been located and have taken measures vis-à-vis third parties necessary for the investor to have reasonable expectation that settlement can be effected when it is due.

Sovereign Debt

For short sales of sovereign debt, the restrictions are more relaxed due to successful lobbying by member states, which were concerned with ensuring liquidity of their debt markets. For sovereign debt, a short seller must either have—

- borrowed the debt instrument or have made alternative provisions resulting in a similar legal effect; or
- entered into an agreement to borrow the debt instrument or have another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due; or
- entered into an arrangement with a third party under which that third party has confirmed that the sovereign debt has been located or have otherwise reasonable expectation that settlement can be effected when it is due.

In addition, the restriction on short sales of sovereign debt does not apply to hedges of long positions in debt instruments of issuers, where the pricing has a "high correlation" with that of the given sovereign debt.

After first notifying ESMA and the competent authorities of the other member states, member states' competent authorities may suspend the restriction for six months (which period can be renewed), where liquidity in its sovereign debt falls below certain thresholds to be set by ESMA. ESMA shall give an opinion with regard to any such suspension.

Prohibition on Uncovered Sovereign CDSs

The Regulation prohibits uncovered CDSs in the sovereign debt of an EU member state. A position in sovereign CDSs will be considered uncovered if the investor does not have an exposure that it is seeking to hedge either to the sovereign debt itself or to assets or liabilities whose value is correlated to the sovereign debt.

After first notifying ESMA and the competent authorities of the other member states, a competent authority of a member state may suspend the prohibition in relation to its own sovereign debt for 12 months and then additional six-month increments where it believes the market is not functioning properly in relation to its sovereign debt or where the prohibition might negatively impact the member state's sovereign CDS market. ESMA shall issue an opinion on the proposed suspension, but cannot prevent it from occurring.

Powers During Stressed Markets

During times of stressed markets, the Regulation allows competent authorities of member states to prohibit or restrict short sales, limit sovereign CDS transactions, impose emergency disclosure requirements and require lenders to notify competent authorities of significant changes in fees required for lending in relation to these transactions. Such powers may be exercised by competent authorities on a temporary basis up to a three-month period and may be extended by further periods up to three months if grounds continue.

Competent authorities may also impose a restriction on short selling of any financial instrument where that instrument has suffered a significant fall in price in a single day. This may be extended up to a further two days if there is a further significant fall in price.

ESMA will be notified of any emergency measures taken by competent authorities in member states and will be responsible for coordinating action to be taken by member states.

Enforcement

Competent authorities in the member states will have all powers necessary to enforce the Regulation, including sanctions and pecuniary measures.

Exemptions

There will be certain exemptions for market makers and in relation to issuers where the principal market for the shares is outside the EU.

CDS positions relating to sovereign debt concluded before November 1, 2012, may be held until the maturity date of the CDS contract.

Further Information

ESMA shall issue implementing technical standards to clarify certain terms in the Regulation and set the liquidity thresholds in relation to sovereign debt, as well as provide other technical standards. The technical standards are to be issued by March 31, 2012. In addition, the EU Commission, in consultation with ESMA, will issue secondary legislation to further define how net short positions are to be calculated.

Links

The press release announcing Parliament's approval of the Regulation can be found here: http://www.europarl.europa.eu/en/pressroom/content/20111115IPR31525/html/Parliament-seals-ban-on-sovereign-debt-speculation-and-short-selling-limitations

The Web site of the European Securities Markets Authority can be found here: http://www.esma.europa.eu/

Foreign Ownership Restrictions in the GCC

By James R. England, Counsel

Introduction

Managers of real estate investment funds with international investors considering investments in real property in the Gulf Cooperation Council (GCC) countries of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates need to be aware of the property ownership regime in the region. Foreign investment in real estate within the GCC is a relatively new phenomenon, and the real estate investment industry in the region is still in its infancy. This is not surprising, because, prior to the turn of the new millennium, the GCC states generally prohibited foreign ownership of real estate within their borders. However, within the last 10 years, the tide has slowly started to turn, and now all of the GCC states permit some form of foreign ownership within their respective territorial borders, albeit subject to substantial restrictions. These restrictions have a significant impact on a potential investor's strategy, as they can materially restrict an investor's options, flexibility, security and, very likely, the return on investment. Set forth below is a high-level overview of the foreign land ownership restrictions in the GCC states.

Key Terms

Certain key terms as they relate to (i) types of real property interests, (ii) nationality and (iii) geographical restrictions are set out below.

1 Types of Real Property Interests

In the GCC, there are three different types of real property interests. The most basic form is a contractual right, such as a short-term lease (a "Contractual Lease"). The second is a long-term ground lease (of up to 99 years) with no true ownership interest in the underlying land (a "Long-Term Leasehold"). The third is fee simple title or full ownership ("Freehold Title").[1] The Contractual Lease is a weak form of real estate ownership because it typically does not survive in the event of bankruptcy, foreclosure or the establishment of a superior interest in the land. In contrast, Long-Term Leaseholds and Freehold Title are generally referred to as "in rem" rights in that they are recordable, "run with the land," typically survive bankruptcy and foreclosure and normally prevent the establishment of superior interests in the land without the consent of the Long-Term Leasehold or Freehold Title owner.

2 Nationality

For the purposes of this article, there are three nationality categories. The first category consists, when referring to a particular country, of such country's nationals ("Local Nationals"). The second category consists of the citizens of the GCC states collectively ("GCC Nationals"). The third and final category consists of every other nationality, excluding GCC Nationals ("Foreigners"). For clarity purposes, each of the respective definitions of Local Nationals, GCC Nationals and Foreigners includes individuals and companies owned by them, and a company owned by Foreigners in any percentage is generally considered to be a Foreigner for purposes of the discussion below, unless a distinction is made otherwise.

3 Geography

For the purposes of defining foreign ownership rights, many of the GCC states divide their territories into two types of geographic zones. The first type of zone consists of specially designated areas ("Investment Zones") inside their borders specifically earmarked

[1] *For the avoidance of any confusion, if, in this article it states that a GCC National/Foreigner is permitted to hold Freehold Title, it should also be assumed that such person is permitted to hold lesser interests in real estate such as Long-Term Leaseholds and Contractual Leases.*

for foreign investment. Significantly, certain countries further designate Investment Zones for specific uses (i.e., residential, commercial, tourism, industrial, etc.). The second type of zone generally consists of the remainder of the land within a given country outside of the Investment Zones, where Foreign ownership of real property is typically prohibited ("Restricted Zones").

Land Ownership Restrictions

Broadly speaking, the GCC states nearly universally permit Local Nationals, GCC Nationals and Foreigners to hold Contractual Leases. An increased level of restriction is placed on Long-Term Leasehold interests, and the greatest number of restrictions are placed on Freehold Title interests. Predictably, Local Nationals have the greatest ownership privileges, followed by GCC Nationals, with the fewest ownership privileges being afforded to Foreigners. Local Nationals can generally hold Freehold Title to property that is not reserved by the state. Additionally, it is generally permissible for GCC Nationals to own real property interests equal to those available to Local Nationals anywhere within another GCC state. However, certain GCC states restrict GCC Nationals' (other than Local Nationals') land ownership rights by (i) restricting land ownership only to Investment Zones; (ii) prohibiting the ownership of Freehold Title (as opposed to Long-Term Leaseholds); (iii) permitting ownership of only a small number of properties in Restricted Zones; (iv) restricting ownership to properties with specific uses; and/or (v) a combination of the above restrictions. Finally, ownership restrictions placed on Foreigners are significantly more cumbersome. Although the restrictions vary significantly from country to country, a few common restrictions include: (a) prohibiting Foreigners from owning real property interests except in Investment Zones; (b) prohibiting ownership of Freehold Title and restricting Foreigners to owning Long-Term Leaseholds; and (c) imposing significant use restrictions on all Foreigner-owned property. Set forth below are brief country-by-country overviews of the land ownership restrictions applicable to non-Local Nationals in the GCC states.

Kingdom of Bahrain

In Bahrain, GCC Nationals are permitted to own Freehold Title to real property anywhere in the kingdom. Foreigners are also permitted to own Freehold Title, but only within designated Investment Zones. Examples of these Investment Zones include, but are not limited to, the Bahrain Financial Harbor, the Bandar Al Seef Area and certain tourism developments, as well as certain residential developments in greater Manama, including the diplomatic area.

State of Kuwait

Kuwait has some of the strictest foreign ownership restrictions in the GCC. Although there is no distinction between Investment Zones and Restricted Zones, and GCC Nationals are permitted to own Freehold Title, Foreigners are not permitted to hold any interest in real estate in excess of a Contractual Lease. Additionally, any company owned by Foreigners, even if commingled with Local National or GCC National ownership, is similarly prohibited from holding Freehold Title or a Long-Term Leasehold interest in Kuwait. Notwithstanding the foregoing, the law regulating direct foreign capital investment provides Foreigners the right to "allotment of lands and real estate required for investment purposes in accordance with the laws and regulations applicable in

the State of Kuwait." Although this law doesn't explicitly set out the type of real estate interest provided by an "allotment," it is presumed that such allotment merely provides a guaranteed right to use the land for as long as the business is operating thereon, rather than an "in rem" ownership interest such as Long-Term Leasehold or Freehold Title.

Sultanate of Oman

In Oman, GCC Nationals are treated on par with Local Nationals and may hold Freehold Title anywhere that Local Nationals are permitted to own property.

Foreigners, whether natural or corporate persons, may acquire Freehold Title to real estate in specific Investment Zones designated by the Ministry of Tourism as Integrated Tourist Complexes (ITCs), subject to certain conditions and procedures. Foreigners may acquire property with existing improvements or undeveloped land for investment purposes in the ITCs. However, if undeveloped land is acquired, then the owner is required to construct buildings on the land within a period of four years of its acquisition, and the land may not be disposed of until the improvements are built or the four-year period expires, whichever occurs sooner. If the owner fails to develop the land within four years, the Ministry of Tourism then has the authority (if it fails to grant an extension) to dispose of the land. Additionally, Foreigners, whether natural or corporate persons, may own Long-Term Leasehold interests (of up to 50 years) in Restricted Zones if the land will be used for the development of the country, and the amount of land is proportionate to the size of its use. Further, any land granted under a Long-Term Leasehold will be subject to the conditions set out in the leasehold document (known as a "usufruct"), which typically restricts the use of the land for a fixed purpose. Finally, any grant of a Long-Term Leasehold interest for Restricted Zones is subject to the approval of the Council of Ministers.

State of Qatar

In Qatar, GCC Nationals may own Freehold Title of up to three real property assets in specifically designated residential areas, provided that, in the aggregate, the properties do not exceed 3,000 square meters. Additionally, GCC Nationals are permitted to own Freehold Title to real property within certain Investment Zones deemed "investment areas." Property in these investment areas can be allocated for myriad uses, including commercial, residential, industrial and tourism, among others. To date, 18 areas have been deemed investment areas.

Foreigners are permitted to hold Freehold Title interests only within three designated Investment Zones (which are separate and distinct from the investment areas). These three designated zones are the Pearl-Qatar, West Bay Lagoon and the Al Khor Resort Project. Foreigners are not permitted to hold Freehold Title within the Investment Zones generally; however, Foreigners can hold Long-Term Leaseholds (of up to 99 years) over real estate in the "investment areas."

Kingdom of Saudi Arabia

GCC Nationals who are individuals may own Freehold Title to up to three private residences in residential areas in Saudi Arabia, but are prohibited from owning property in the two holy cities of Makkah and Madinah. Individual GCC Nationals cannot own more than 3,000 square meters in aggregate area of residential space, must use the space only for residential purposes and cannot dispose of the property until four years after it is acquired and registered in the new owner's name. Additionally, GCC Nationals that are corporate persons may also hold Long-Term Leasehold interests in real property for business purposes, provided the real property is exclusively used for conducting the business for which it is licensed and the size of the property is proportionate to the actual business use. Also, the property may not be disposed of unless the business ceases conducting business activities. If the GCC National company is licensed to conduct real estate sales, then the sale of the property acquired by the company is permitted in the normal course of business.

Foreigners are also entitled to own real property in Saudi Arabia. However, ownership is subject to a number of significant restrictions. An individual Foreigner may own property in Saudi Arabia if he has normal legal residency status therein and has a permit from the Ministry of the Interior. However, Foreigners cannot own land or property in the holy cities of Makkah and Madinah, and there are also restrictions regarding their ability to hold Contractual Leases in these cities. Ownership of Long-Term Leasehold or Freehold Title to residential property by individual, non-resident Foreigners remains prohibited. Furthermore, significant restrictions exist for companies owned by Foreigners, and all Foreigners seeking to own real property in Saudi Arabia must obtain a license from the Saudi Arabia General Investment Authority (SAGIA). A Foreigner-owned company—defined as a company having "any" percentage of non-GCC National ownership—must have a legal presence in Saudi Arabia. This legal presence entails partnering with a local Saudi company, and a new company will need to be established to hold the land on the Foreign company's behalf. The strict stance on Foreigner's ownership of real property appears to be softening, albeit slowly. The Saudi government has recently announced that, for the first time, non-resident individual Foreigners and companies owned by them may be able to own property in the King Abdullah

Foreign Ownership Restrictions in the GCC

Economic City project near Jeddah, but full details have yet to be released.

United Arab Emirates

In the United Arab Emirates (UAE), each emirate is free to enact its own legislation with respect to foreign ownership of land. The applicable restrictions regarding the emirates of Abu Dhabi and Dubai are discussed herein.

In Abu Dhabi, only Local Nationals are permitted to obtain Freehold Title and/or Long-Term Leaseholds in Restricted Zones. GCC Nationals and Foreigners are restricted to holding Contractual Leases in the Restricted Zones. GCC Nationals are permitted to hold Freehold Title to land only within certain designated Investment Zones. Foreigners are never permitted to hold true Freehold Title, but they can hold Long-Term Leasehold interests in Investment Zones as well as quasi-freehold interests in "floors" and units of buildings within Investment Zones, but ownership of such "floors" and units does not grant an interest in the underlying land itself. The Investment Zones in Abu Dhabi include, but are not limited to, Sowwah Island, Lulu Island and Masdar City, among several others. In Dubai, Freehold Title rights are extended to GCC Nationals as well as Local Nationals in the Restricted Zones. Foreigners can own Freehold Title within specific Investment Zones, such as certain areas in the Dubai Marina, but cannot hold Freehold Title in the Restricted Zones. Additionally, it should be noted that any company that is not 100 percent owned by Local Nationals (or GCC Nationals, as the case may be) is considered to be a Foreigner for purposes of the ownership restrictions in the UAE.

Finally, in the UAE an important distinction is made in respect of Long-Term Leasehold interests. Long-Term Leasehold interests are divided into two distinct types. A "musataha" is a long-term (up to 50-year) lease with a mandatory development obligation, and a "usufruct" is also a long-term (up to 99-year) lease, but development of the land is not permitted. It is permissible to contractually "staple" a musataha and usufruct interest, so that a purchaser can buy a property and develop it under the musataha, and then hold it for a further period of 99 years under a usufruct.

Additional Considerations

A number of additional issues are applicable to real estate investors in addition to the foreign ownership restrictions. For example, investment funds seeking to own property, establish and/or solicit investors within the GCC states must also take into account local securities laws and fund registration/licensing requirements. Furthermore, visa restrictions and the length of visas issued to property owners is also a concern. To illustrate a few of these issues, in Saudi Arabia, for example, Foreigners (and companies owned by them) need to obtain a license in order to conduct real estate investment activities (whether or not the person/company is an "investment fund"). The license must be obtained from the SAGIA and is subject to a number of conditions. Similarly, under newly proposed (but not yet effective) legislation in the UAE, the marketing of a foreign fund in the UAE (outside of the Dubai International Financial Centre) will require (i) the approval of the Emirates Securities and Commodities Authority (ESCA) and UAE Central Bank and (ii) the appointment of a local distributor licensed by the ESCA. Additionally, the UAE does not issue long-term visas even to property owners. At present, individual property owners must renew their visa every six months (at a cost of over $500). Finally, certain countries have "anti-fronting" provisions that prohibit Foreigners from intentionally involving Local National companies to act as "straw men" or adopting other obfuscating structures in an attempt to circumvent the foreign ownership restrictions. The presence of anti-fronting laws demands that investors carefully vet their structures to ensure that they do not violate the foreign ownership restrictions. The specific securities laws, registration/licensing requirements, visa regulations and anti-fronting regulations are beyond the scope of this article, but it is important to keep these potential restrictions in mind (in addition to the foreign land ownership restrictions) when contemplating business activities in the GCC.

Final Thoughts

The ever-changing political and legislative landscape in the GCC demands that investors undertake careful diligence prior to soliciting investors, managing assets, conducting business or making real estate investments in the GCC in order to ensure compliance with all local laws. New real estate regulations are being debated every day by GCC governments, as these countries struggle to keep their laws ahead of the pace of development and seek to encourage foreign investment to diversify their economies away from oil.

Participating in China's Private Equity Industry

By Ying Z. White, Partner

With just about 10 years of history, Chinese private equity is still in its infancy. However, it appears to be on track to repeat the same growth story that took place in mature markets such as the United States and Europe starting in the 1990s. According to a recent survey by the Emerging Markets Private Equity Association, 40 percent of investors plan to increase exposure to China in the next two years, placing China at the top of the list among emerging markets for investor allocation.

Drivers of Change

Among the latest trends in Chinese private equity has been the large upsurge of growth in renminbi (RMB)-denominated private equity funds (RMB funds). According to industry statistics, RMB fundraising reached $6.87 billion in 2010, compared to $4.3 billion in capital raised by offshore United States dollar-denominated funds (USD funds) investing in China in the same year. Both international investors and sponsors are increasingly interested in RMB funds as vehicles for making investments into China.

Several forces are encouraging this drive to RMB funds. For one, regulatory changes in 2007 made it difficult for international private equity managers to utilize traditional special purpose vehicle (SPV) structures for their China investments. In the past, Chinese companies would set up offshore structures with the ultimate holding companies incorporated in Hong Kong, BVI, the Cayman Islands or elsewhere outside China. These offshore companies could take in U.S. dollar investments from private equity funds and then IPO outside of China. Since the regulatory changes introduced in 2007, this offshore IPO-oriented structure once widely used by offshore USD funds investing in China has become less popular.

At the same time, the Chinese government began encouraging more exits taking place on China's domestic exchanges, either in Shanghai or Shenzhen. To facilitate this, the Chinese government has taken steps such as retooling the Shenzhen exchange to act as China's NASDAQ for small caps. In addition, when listing a portfolio company on a domestic stock exchange, the Chinese government has made the approval process faster and more predictable for companies backed by domestic RMB fund investors than for companies backed by offshore private equity funds. This speed differential at the exit stage has resulted in a market preference for domestic RMB funds.

Additional factors encouraging the growth of RMB funds include RMB appreciation and wider acceptance of the RMB outside of China, adding potential value for any RMB-based investment. The combination of these changes and market-driven preferences has been beneficial for RMB-denominated private equity funds. Industry statistics show that, in 2010, 146 RMB funds were established. The market has evolved to become one anchored by both traditional, larger offshore China-focused funds investing in China and new, smaller onshore RMB-denominated funds making domestic Chinese investments.

RMB Funds

Participating in China's Private Equity Industry

RMB Fund Alternatives

Essentially, offshore USD funds are treated as foreign investors and, therefore, subject to governmental approvals, ownership and other restrictions when investing in Chinese companies. This bifurcation is largely attributable to China's foreign-direct investment (FDI) and currency-control regimes.

See comparison table comparing offshore USD-denominated China funds and onshore RMB-denominated China funds.

USD/EUR-Denominated China Funds	RMB-Denominated China Funds
Organized under foreign law	Organized under Chinese law
Non-Chinese investors	Developing Chinese investor base
Investments in China subject to China's foreign director investment (FDI) and foreign exchange (FX) restrictions	Investments in China can get domestic investor treatment
Typically exit through offshore IPOs, and there are successful onshore IPOs in recent years	Typically exit through domestic IPOs or trade sale

Domestic RMB funds are generally not subject to those restrictions. In particular, if funded entirely by domestic investors, an RMB fund can invest in a broader range of industries and sectors in China than its USD fund counterparts. Because the RMB fund invests using local currency, central government approvals are not required for the conversion of foreign currency into RMB and associated repatriation.

Generally, there are two types of onshore RMB Funds: (i) purely domestic RMB funds and (ii) foreign-invested RMB funds. Purely domestic RMB funds are funds denominated in RMB, organized under Chinese law, raised from domestic Chinese investors and invested in domestic Chinese companies. Foreign-invested RMB funds are also denominated in RMB and organized under Chinese law, but are essentially foreign-invested enterprises (FIEs) with foreign ownership.

Within the foreign-invested RMB funds category, there are two organizational forms available for investors and sponsors. One comprises foreign-invested venture capital enterprise (FIVCEs) and the other foreign-invested limited partnerships (FILPs). Regulations governing the establishment and operations of FIVCEs have been in place since 2003, while the rules governing the establishment of FILPs took effect only in March 2010. However, the FILP rules are not directly applicable to FILPs intended for private equity investments. Hence to date, RMB funds organized as FILPs, i.e., those with foreign-investor participation, are governed by various local rules and policies such as those issued by the municipal governments of Beijing, Shanghai, Tianjin and Chongqing.

These rules for FILPs are new and still under development. As a result, not many have been established. In today's market, the dominant structures still parallel USD and RMB funds (parallel funds) and FIVCEs (JV funds). Parallel funds require two separate funds making China investments alongside each other, while FIVCEs provide the convenience of combining domestic and international capital into one fund vehicle. Each structure has its own advantages and utility as well as disadvantages and challenges. A summary chart below compares the key features and issues between parallel funds and FIVCEs.

Conclusion

Although the RMB funds sector is set to enjoy steady growth in connection with the overall development of the Chinese economy, interested investors and sponsors should determine which structure is most suitable based on their own specific circumstances. They need to consider such factors as the fund's investment strategy, target investment sector, level of competition over target investment opportunities and investor sensitivity to conflicts of interest inevitably present in the parallel funds structure. Doing so will help maximize the chances for success.

Comparison of RMB Fund Alternatives

<table>
<tr><th></th><th>(1) FIVCE –
aka 'JV Fund'</th><th colspan="3">(2) Parallel Fund – an onshore RMB fund alongside an offshore USD fund</th></tr>
<tr><th></th><th></th><th>RMB Fund</th><th colspan="2">USD Fund</th></tr>
<tr><td>Structure</td><td>Non-Legal Person Foreign Invested Venture Capital enterprise, pooling capital from offshore USD investors and onshore RMB investors into one vehicle.</td><td>Onshore: Limited Partnership Enterprise ("L.P.").</td><td colspan="2">Offshore: Cayman LLC or L.P.</td></tr>
<tr><td>Management</td><td>• Joint management committee.
• May delegate management to a VCIME or another FIVCE;
• VCIME can be a domestic Chinese-funded, a foreign-invested or an offshore venture capital investment management enterprise.</td><td>Int'l GP establishes a JV or WFOE in China.</td><td colspan="2">Int'l GP.</td></tr>
<tr><td>Investors</td><td>Int'l investors and domestic investors.</td><td>Domestic Chinese investors in RMB fund.</td><td colspan="2">Int'l investors in USD fund.</td></tr>
<tr><td>Major Approvals Required for Establishment of Fund</td><td>Requires MOFCOM (central or local) approval.</td><td>Requires no MOFCOM approval (but local DRC approval may be required).
Register with local SAIC.</td><td colspan="2">Applicable offshore law.</td></tr>
<tr><td rowspan="2">Major Approvals for Portfolio Investments in China</td><td rowspan="2">• In encouraged or permitted business sectors: requires filing at local MOFCOM.
• In restricted business sectors: requires MOFCOM (central or local) approval.</td><td rowspan="2">Requires no MOFCOM or SAFE approval.
Register with local SAIC.</td><td>Invests in offshore SPVs.</td><td>Invests in onshore portfolio companies</td></tr>
<tr><td>Requires MOFCOM and SAFE (central or local) approvals.</td><td>Requires MOFCOM and SAFE (central or local) approvals</td></tr>
<tr><td>Exit</td><td>• Typically exits onshore.
• Listing onshore: requires CSRC and MOFCOM approvals.</td><td>• Typically exits onshore.
• Listing onshore: requires CSRC approval.</td><td>Exits offshore.</td><td>• Typically exits onshore.
• Listing onshore: requires CSRC and MOFCOM approvals.</td></tr>
<tr><td>Tax</td><td>• Chinese and int'l investors separately declare and pay their respective Chinese income taxes; or
• FIVCE may calculate and pay Chinese income tax for all investors subject to approval.</td><td>• Income tax paid at partner level.
• Local govts offer favorable tax policies.</td><td colspan="2">Applicable foreign laws.</td></tr>
<tr><td>Uncertainties/ Challenges</td><td>• Required to invest mainly in high- and new-tech enterprises but in practice, classification of high and new technology is unclear.
• Subject to sector-specific and other foreign investment restrictions.
• Uncertainty over exits on domestic stock exchange.
• Applicable tax incentives still to be clarified.</td><td>• Conflicts of interest in allocation of investment opportunities, devotion of time and resources of investment principals, and profit distribution between onshore RMB fund and offshore USD fund are major issues of concern to investors.
• Heavy reliance on local rules and policies can introduce additional uncertainty.</td><td colspan="2">• Conflicts of interest in allocation of investment opportunities, devotion of time and resources of investment principals, and profit distribution between onshore RMB fund and offshore USD fund are major issues of concern to investors.
• Heavy reliance on local rules and policies can introduce additional uncertainty.</td></tr>
</table>

ABBREVIATIONS:

CSRC — China Securities Regulatory Commission
FIVCE — Foreign-Invested Venture Capital Enterprise
GP — General Partner
JV — Joint Venture
MOFCOM — Ministry of Commerce
SAFE — State Administration of Foreign Exchange
SAIC — State Administration of Industry and Commerce
VCIME — Venture Capital Investment Management Enterprise
WFOE — Wholly Foreign-Owned Enterprise

NOTES:

1. Onshore RMB funds can typically be organized in the form of a company, venture capital investment enterprise, trust or limited partnership. This summary chart focuses on the limited partnership structure, which has become the preferred organizational form for both international and Chinese investors.
2. FIVCE can also be organized as a company. However, the nonlegal person form is more akin to a limited partnership and is used for this comparison exercise.

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