



Start-ups, spin-outs and first time funds

A fundraising toolkit

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Introduction

Simmons & Simmons' reputation in private funds has been built on the back of our specialisation in start-up, spin-out and first-time funds, and we are proud to be a strategic partner of the BVCA in providing training on the establishment of new private fund management entities and the launch of their debut funds through its annual workshop for first-time fund managers. Across the globe we advise on the full range of legal, regulatory and tax issues for new participants in the industry.

We are acknowledged by the leading legal directories, including Chambers and Partners, the Legal 500 and the International Who's Who of Private Funds Lawyers, as a firm recognised for its specialisation in private fund formation.

We have prepared this Toolkit to provide an overview of the legal process and legal issues involved in raising a first time private fund and establishing a fund management business.

For a summary of the steps involved in raising a fund and establishing a fund management business, see Section 1, 'Key milestones'. For more detailed information, including step by step explanations, see Section 2, 'Fundraising' and Section 3, 'Establishing a fund management business'. The 'Questionnaire' in Section 4 brings together the initial questions which you will need to consider with your advisers.

Sections 5 and 6 discuss how Simmons & Simmons can help you manage your legal costs and the qualities that we think make Simmons & Simmons the first choice law firm for advising on first time fundraisings.

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1



Key milestones

Set out below are the key milestones in raising a private fund and establishing a fund management business.

Fundraising

Appointment of advisers and service providers
(e.g. legal and tax advisers, placement agent,
compliance consultants, administrator and auditors)

Structuring of fund (commercial, tax and
regulatory issues)

Design terms of the fund

Draft marketing material (one pager, road show
presentation, PPM, due diligence pack, etc.)

Initial discussions with investors and distribution of
marketing material

Commercial due diligence by investors

Drafting of fund documentation (limited partnership
deed, management deed, subscription deeds)

Investors review fund documentation

Negotiations with investors (amendments to fund
documentation and drafting of side letters)

Receipt of investors' completed subscription deeds

Money laundering and acceptance checks

First closing

Subsequent closings

Post closing tasks (e.g. bibles)

Manager establishment

Establish proposition, key people and resources

Choose a name

Identify any employment/confidentiality issues
involving former employers (e.g. ability to use prior
investment track record)

Structuring of manager (commercial, tax and
regulatory issues)

Liaise/negotiate with any strategic partner. Agree terms
on which manager will be established, draft and enter
into documentation (shareholders agreement or limited
liability partnership deed) and incorporate entity

Submit regulatory application

Lease premises/employ staff/install and test
IT systems

Finance management entity

Regulatory authorisation received

Ongoing compliance with applicable obligations,
including maintenance of regulatory capital

We regard all fundraisings as a priority and progress the legal aspects as quickly as the manager can progress discussions with potential investors. It is important, however, to make sufficient allowance for obtaining the necessary regulatory authorisation for the manager.



2

Fundraising

We have set out below a step by step explanation of the legal process for forming a private fund which invests in private equity, real estate, infrastructure, debt or any other type of illiquid assets and how we can assist you with each stage of this process so that you reach your fundraising objectives as efficiently, smoothly and cost-effectively as possible.

2.1 Appointment of advisers

The establishment of a fund will involve the appointment of a number of advisers and service providers. These typically include a legal/tax adviser, a placement agent, a compliance consultant, an administrator and an auditor. Other service providers such as custodians and valuers may also be required.

- **Legal / tax adviser** – is required in order to structure the fund, advise on its terms, prepare and review documentation, undertake negotiations with investors and close the fund.
- **Placement agent** – will advise on the fund's commercial terms and their acceptability to potential investors, assist with the preparation of marketing plans and materials, identify potential investors and introduce them to the manager, assist with investors' due diligence and generally facilitate the relationship between the manager and the investors both during and after the fundraising. Placement agents generally charge an upfront signing on fee plus a success fee which is calculated as a percentage of the funds raised, although often this may be paid over time in a number of instalments. In addition, it is increasingly common for placement agents to take a percentage of the fund's carried interest or performance fees as part of their fee arrangements.
- **Administrator** – will be responsible for carrying out many of the day to day tasks involved in administering the fund. They can advise on operational issues which may arise with a particular fund structure and how they can be resolved. For example, they will be responsible for maintaining the records and accounts of the fund and assist with preparing reports for investors. They can also liaise with auditors on matters such as the potential for the fund's assets to be consolidated onto the fund's and the manager's balance sheet. Therefore, the appointment of an administrator with the correct skill set is important both to the fundraising and the ongoing operation of the fund. The administrator's fees are typically borne by the fund as part of the fund's operating expenses.
- **Compliance consultant** – can assist with both the preparation of the FSA application as well as provide ongoing support in developing your firm's compliance infrastructure and managing your ongoing compliance obligations.

The appointment of these advisers and service providers will involve determining the services which need to be provided, selection of appropriate service providers and the review and negotiation of agreements under which they are appointed. Service providers, particularly placement agents, will also conduct due diligence on managers, especially start-up managers, to gauge the likelihood that the fund can be raised and the target commitments reached.

We have extensive experience of the process of appointing advisers and services providers and can advise you on this process so that your fundraising can proceed without delay. With our knowledge of market terms we can review agreements for the appointment of those services providers quickly and effectively.

2.2 Structure

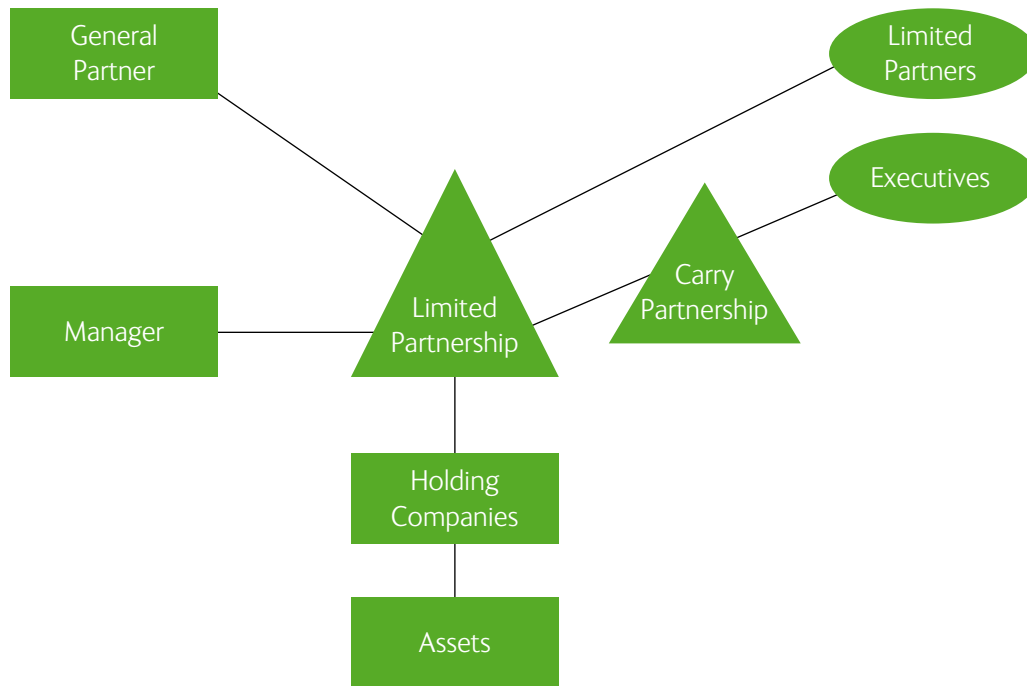
A critical step in any fundraising is the development of an appropriate structure for the fund. The fund structure will generally have the following objectives:

- **Tax efficiency** – investment into the target asset class on a tax efficient basis from the perspective of investors, the fund manager and individual recipients of carried interest/performance fees.
- **Investor participation** – facilitating participation by as broad a range of investors as possible, taking into account the target investors for a particular fund.
- **Regulation** – establishment of a structure which minimises the regulatory burden on the fund and the manager and allows for any necessary regulatory authorisations/permissions to be obtained within the fundraising timeframe.
- **Administration** – the fund structure must be able to work practically on a day to day basis for the fund's manager, its executives and staff.

A typical structure (see Diagram 1) will involve:

- The establishment of a tax transparent or tax exempt fund entity (such as a limited partnership or an offshore company) which is suitable for the target investors.
- The establishment of an appropriately authorised entity to manage and operate the fund and carry out transactions on behalf of the fund (see Section 3).
- The design of a tax efficient structure for the receipt and distribution of carried interest/performance fees to the manager and/or its executives (e.g. a limited partnership in which executives hold “points” entitling them to a share of the carried interest).

Diagram 1 – A typical limited partner/general partner fund structure

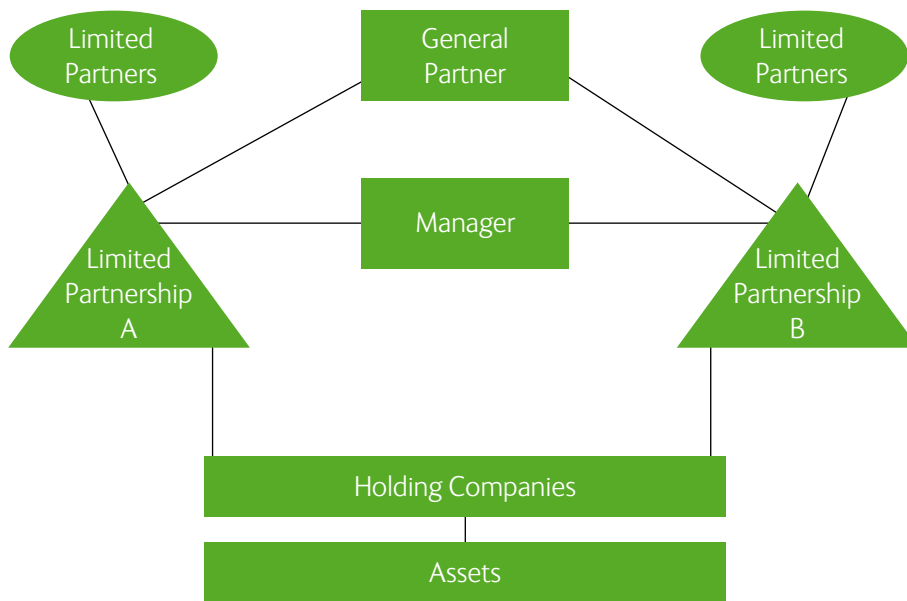


- The development of a tax efficient “holding” structure underneath the fund to facilitate investment into the chosen asset class/geographic area (e.g. in Europe the use of Luxembourg and/or Dutch entities often provides access to a favourable network of double tax treaties whereas other jurisdictions such as Cyprus, Malta and Mauritius may be more appropriate for other funds). Investors will often want to review the proposed fund structure and holding structure to determine for themselves the tax efficiency of an investment in the fund and to ensure that sufficient thought has been given to the structure prior to actual investments being made. It is also crucial to ensure the structure adopted gives operational flexibility to repatriate proceeds to the fund.

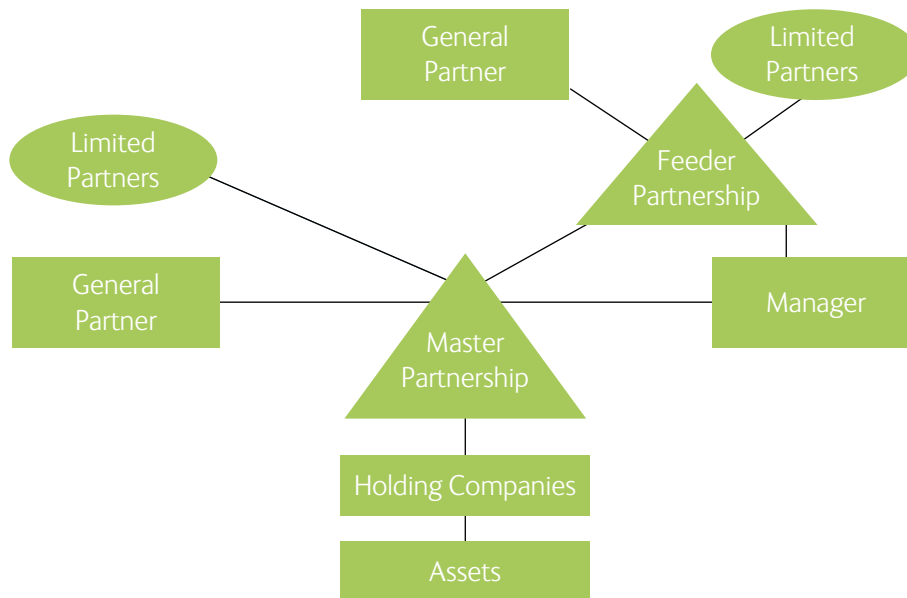
Structures involving certain categories of investors (e.g. both US taxable and tax exempt investors) will require the establishment of parallel or master/feeder structures (see Diagram 2) which, while consisting of several distinct entities, operate from a commercial perspective as a single fund.

Diagram 2 – Parallel fund and master/feeder fund structures

Parallel funds*



Master/feeder funds*



At Simmons & Simmons, our integrated funds, tax and regulatory practices work together with our clients to develop an optimal structure that addresses their particular needs. Our tax team assists in maximising the tax efficiency of the structure at all levels while our regulatory team can assist with all aspects of authorisation and regulatory compliance. As we have experience working in all the major onshore and offshore jurisdictions, we are “structure neutral” and can work with you to develop the best structure for your fund. Where your fund involves the establishment of offshore entities, we work with leading offshore lawyers to assist you in putting those structures in place. Our market tested suite of documents is designed with a variety of structures in mind so that the need to implement feeder or parallel funds (even on short notice) does not delay a fundraising.

2.3 Terms

The next step is to decide upon the terms on which the fund will be promoted to investors. While the detailed terms describing how the fund will be operated will be set out in the fund’s documentation (e.g. limited partnership deed), the key terms will be formulated at an earlier stage for the purposes of preliminary marketing and discussions with investors.

Fund terms must strike a careful balance between presenting potential investors with an attractive investment opportunity that reflects established market practice and being commercially advantageous to the manager (e.g. by maximising its receipt of fees and carried interest). The precise terms which are suitable for a fund vary depending on the asset class in which it will invest, the manager and its track record and the investors who are being targeted. We will be able to discuss this with you in more detail.

The key terms for a fund will typically consist of:

- **Investment strategy** – This sets out the strategy that the fund will pursue including the types of assets that it will endeavour to acquire and the geographic area in which they are located. The investment strategy must be supported by up-to-date and credible economic research and analysis.
- **Target returns** – These are the returns which the manager is targeting for the fund and will need to be based on credible assumptions.
- **Target fund size** – The total amount, in terms of investor commitments, which the fund is attempting to raise. There must be sufficient opportunities to invest that amount and it will be need to be a realistic amount for a first time fund.
- **Term of fund** – This is the period of time until the fund terminates. Often it can be extended either at the discretion of the manager or with the consent of investors. It should be sufficient to allow for the investment strategy to be successfully executed.
- **Closings** – Investors are admitted to the fund at a number of “closings” that typically take place over a period of up to 12 months (or longer in the current fundraising climate). Each investor’s commitment is generally backdated to the date of the first closing so that they participate in any unrealised investments made prior to the time they are admitted. Investors participating in a later closing will pay an interest charge to the existing investors in respect of the amount that would have been drawn down from them had they invested in the fund at the first closing. The investor

will also pay an interest charge to the general partner in respect of its backdated management fee or general partner's share. In order to achieve this there is a mechanism in the fund's documentation (e.g. limited partnership deed) for adjusting the amounts contributed by investors after each closing.

- **Drawdowns** – Each investor makes a commitment to the fund when it is admitted. That commitment is then drawn down as it is required in order to make investments and meet expenses and liabilities of the fund. Investors are normally given 10 business days notice of each drawdown. The fund's documentation (e.g. limited partnership deed) will set out the consequences for an investor who fails to fund its commitment.
- **Withdrawals and transfers** – As investors typically make a commitment for the duration of the fund they cannot (other than in certain limited circumstances) choose to withdraw from the fund or redeem their interest. They can, however, transfer their interest in the fund (e.g. sell that interest in the secondary market) although such transfers are normally only allowed at the discretion of the manager.
- **Investment period** – This is the period of time during which the fund can acquire investments. Often it can be extended either at the discretion of the manager or with the consent of investors. After the end of the investment period, draw downs can usually only be made to meet costs and expenses of the fund and to make limited follow-on investments but not to acquire new investments.
- **General partner's commitment** – This is the amount that the management team will invest in the fund. Typically, investors will expect this to be at least 1% of the total commitments to the fund. For first-time funds, it is possible that the general partner's commitment will be met out of the general partner's share or management fee in cases where the general partner or manager does not have sufficient capital to meet the commitment upfront.
- **Currency** – The currency that will be used for all drawdowns, distributions and record keeping by the fund. This will often but not always be the currency in which the fund will make investments. For example, a Euro denominated fund may make some investments outside the Eurozone or a fund that invests in emerging markets may be denominated in US dollars. If investments can be made in other currencies, consideration must be given to currency hedging and the disclosure of foreign exchange risks to investors.
- **Management fee/general partner's share** – This is usually calculated as a percentage of total commitments during the investment period. Subsequently, it is usually calculated as a percentage of the amount of commitments drawn down (often only to the extent that they have been used to acquire investments) but taking into account investments that have been written off or, possibly, written down.
- **Carried interest/performance fees** – There are various ways of determining the amount of carried interest/performance fees and there are variations in market practice between funds investing in different asset classes (e.g. private equity, real estate, infrastructure). The classic private equity model involves the proceeds of the realisation of each investment and any income being paid to investors until they have received either all of their commitments which have already been drawn down (commonly referred to as "fund as a whole carry") or only their drawn down commitments used to fund the cost of the investment which is being realised, any losses on other investments which have already been realised together with any write downs on unrealised investments

(commonly referred to as “deal by deal carry”). Any surplus is then split 80:20 between investors and the recipients of carried interest, subject to the investors first receiving a minimum “preferred return”. For first time European funds, “fund as a whole carry” is typically used.

- **Clawback/escrow** – The recipients of carried interest/performance fees will be required to return some of the amounts which they have been paid at the end of the fund’s term if, when calculating the carried interest/performance fees that should have been paid on an aggregate basis in respect of all the fund’s transactions, an excess of carried interest/performance fees has been paid. In order to provide security for this obligation, a percentage of the amounts that they receive during the term of the fund may be held in escrow.
- **Abort costs** – the manager may need to commit its own resources to potential investments before an investment is made. The limited partnership deed will specify when the manager can recover these costs from the fund.
- **Transaction fees** – These are fees charged by the manager to portfolio companies in which the fund has invested. Generally, these are split between the manager and the fund in an agreed ratio (normally by off-setting a portion of them against the general partner’s share).
- **Successor funds** – Typically, the manager and its associates will be prohibited from establishing a successor fund with a similar investment strategy until the vast majority (normally 75%) of commitments of the existing fund have been drawn down or reserved for future investment. It is important to set out clearly what steps a manager can take in establishing a successor fund before this restriction applies. The manager will want to ensure that there is no gap between the end of one fund’s investment period and the closing of its successor so that it is not left unable to make investments while a new fund is being raised.
- **Key persons** – Investors will require that certain members of the management team who they deem to be essential to sourcing and executing transactions be named as “key persons”. Typically, if they cease to be involved in the management of the fund or cease to devote a certain amount of time to it, the fund is prevented from making new investments until replacements acceptable to the investors are found.
- **Removal of general partner/manager** – Generally, a general partner/manager can be removed by investors either for cause (e.g. fraud or wilful default) or without cause (“no-fault divorce”).
- **Expenses** – The fund will bear all the costs and expenses related to its ongoing operation. It will also (up to a cap) bear those costs and expenses incurred in the establishment of the fund and sometimes also of the manager. This includes legal costs but excludes placement agent’s fees.
- **Advisory committee** – Funds often have a committee of representatives of certain investors (perhaps chosen at the discretion of the manager or because they have invested a certain amount in the fund) who are consulted on matters such as conflicts of interest and whose consent can be sufficient for certain matters, such as waivers of investment restrictions.
- **“Family and Friends” vehicles** – Such vehicles may be established to allow “friends of the fund” such as employees of the manager or strategic partners to invest in or alongside the fund and pay reduced management or performance fees to the fund.

Our role is not just confined to the drafting of documents, with our wide experience of fund formation and knowledge of market terms, we can work with you and your placement agent to develop fund terms that incorporate the latest market developments as well as being commercially advantageous to the manager. We maintain a database of fund documentation that allows us to capture and analyse the latest trends in fund terms. We also act for a number of investors and can therefore anticipate the position that investors may take on particular fund terms.

2.4 Blind pool funds and pledge funds

In a traditional “blind pool” structure for a private fund, the manager has the discretion, subject to the fund’s investment strategy and restrictions, to decide what assets the fund will acquire. Although there may be some limited circumstances in which investors are excused from participating in an investment (for example, if it is unlawful for a particular investor to participate in a certain type of investment), investors are otherwise bound, up to the amount of their commitment, to participate in each of the investments chosen by the manager and are not able to determine, either individually or as a group, what assets the fund will acquire.

However, alternative structures do exist. For example, in a “pledge fund” each investor enters into an agreement with the manager where they pay a fee to the manager for a set period of time and, in return, the manager undertakes to offer all the investment opportunities of a particular type that it sources to those investors. Under this structure, an investor can decide whether it wants to participate in each investment. A separate fund entity (e.g. a limited partnership) is established for each investment for those investors who wish to participate in it.

In a pledge fund, some matters, such as the type of investments that will be offered to investors and the fee for sourcing them, are dealt with in the agreement between the manager and each investor. In addition, pro-forma documentation that will be used for each investment (e.g. a limited partnership deed) is agreed between the manager and the investors upfront. It sets out what structure will be used for each investment and the terms that will govern that investment such as the calculation of carried interest/performance fees and the fee for managing the asset.

We can discuss these options with you in more detail, their pros and cons and assist you in deciding what would be most appropriate for your fund. We are also able to prepare all of the relevant documentation for these structures (see Section 2.7).

2.5 Seed portfolios and warehoused assets

While the manager may have the discretion to make investments following a fund’s closing, the fund may also have a “seed portfolio”. A seed portfolio is a pre-determined group of assets which the fund will acquire, usually at its first closing. Potential investors will be aware of the identity of these assets as well as their proposed transfer values (determined either by negotiations between the buyer and seller if the parties regard the transaction as a “secondary direct transaction” or determined by an independent valuation in the case of a “related party transaction”) and the other terms on which it is proposed that the fund will acquire them. Investors will normally want to conduct due diligence on these assets and the terms of their acquisition. Therefore, the manager will need to establish a data room or other means of ensuring that the relevant materials are available for investors to inspect and be prepared to answer questions about them.

A fund may also have “warehoused assets”, these are assets that are normally acquired by the manager (or its associates) during the fundraising but prior to the first closing of the fund on the basis that they will be transferred to the fund once it is closed. This provides the manager with the flexibility to make investments while the fund is still being raised. Of course, in order to do this the manager will need to have sufficient funds or finance available to make such investments on its own account prior to the commitments of the investors being available (this might be provided by a “cornerstone” investor).

The terms on which a seed portfolio or warehoused assets will be acquired by the fund will be set out in the funds’ legal terms.

2.6 Marketing

One pager and road show presentation

The initial marketing material for a fund will generally include a one pager and a road show presentation to investors. At Simmons & Simmons, we recognise that conveying your message to investors clearly and rapidly is important in securing the support of “cornerstone” investors. We have the resources and experience to review these marketing materials, to advise you on the legal risks involved and to supply you with appropriate disclaimers, quickly and typically within 24 hours.

Private placement memorandum

The principal marketing document for a fund is the private placement memorandum. This document sets out the investment strategy and objectives of the fund, a description of the manager and its key staff as well as summarising the legal terms. The key sections normally cover:

- Executive summary
- Executive summary of principal fund terms*
- Description of market opportunity, investment strategy and related business sections
- Description of the manager, the management team and investment process, including deal flow and exit options
- Investment track record information (and basis of valuations and calculation of IRRs)
- Transaction summaries
- Principal fund terms*
- Risk factors and potential conflicts of interest*
- Description of tax and other regulatory considerations*

Once the principal terms of the project have been determined, we can produce a draft private placement memorandum. This will include all the legal sections (indicated by an “*” above) as well as full definitions and details of the regulatory position relating to the marketing of the fund. We then

work with our clients to help develop and integrate the remaining business sections into the private placement memorandum and tailor it to their specific needs.

Regulatory issues

In many jurisdictions the fund itself will be unregulated (e.g. in the UK it will typically be an unregulated collective investment scheme) and, therefore, there will be no need to seek any regulatory approval for the fund itself. The manager of the fund will, however, generally need to be appropriately authorised (see Section 3.6).

Depending on the domicile of the manager, it is usually possible for the manager to carry out fundraising activities on behalf of the new fund even before the manager has received a regulatory license from its home state regulator (e.g., before authorisation by the FSA in the UK). In order to do this, and at the appropriate time, the manager will need to set up a fund structure which is grouped with it. It should be noted, however, that even where a group exemption is used, separate marketing restrictions will continue to apply and will need to be complied with by the manager both in its home state and overseas - as is explained in the two paragraphs below.

When marketing a fund, it is necessary to comply with any applicable marketing restrictions set out in the regulatory regime in the countries in which you are marketing, for example, complying with the FSA's requirements in the UK or those of the SEC in the United States. Each country's requirements are different and are subject to change. The process of checking the marketing restrictions in each country in which it is proposed to promote the fund can be difficult, time consuming and costly. A failure to comply with local requirements can make the manager and its staff subject to civil and criminal penalties in the relevant countries and may also result in agreements with investors being unenforceable.

In order to overcome this problem, Simmons & Simmons has developed a market-leading solution, called Navigator. Navigator gives clients instant access to up-to-date information on the marketing of private funds in all major countries. Navigator is available on a subscription basis. Alternatively, we are also able to provide advice on marketing restrictions on a case by case basis.

Investor due diligence

Potential investors will customarily engage in detailed due diligence of the manager and the fund proposition. This will include topics such as:

- the investment strategy and target returns of the fund, including the macroeconomic analysis underpinning the investment opportunity and the assumptions underlying target returns;
- the likely composition of the fund's investments, including diversity, geography and type;
- the team members, their relevant skills and experience, the extent to which they have invested together previously;
- whether the team members have access to deal flow and whether that deal flow is proprietary;
- track record attribution and the precise role that team members had in those deals (e.g. to what extent were the relevant individuals responsible for sourcing, acquiring, managing and disposing of the relevant investments?);

- track record performance analysis (to what extent were profits generated from the use of leverage or rising markets, rather than value creation in the assets themselves?);
- the amount which the team members themselves propose to invest in the fund. Investors will generally look for the members of a spin-out or start-up to invest at least 1% of the fund's total commitments. Where this would create a liquidity problem for the management team, we can advise on ways in which to manage this, for example, by 're-investing' management fees during the initial term of the fund.

The investors' due diligence process is generally the most time-consuming and difficult stage of a fundraising for a manager. It will involve the manager establishing a data room or other means of providing a detailed due diligence pack to investors, participating in telephone calls and meetings which may include a visit to the manager's premises. If a placement agent is being used, it will greatly assist in facilitating this process.

2.7 Fund documentation

The establishment of a fund will involve a range of legal documentation which, depending on the precise structure, will include:

- **Limited partnership deed** – establishes the partnership and details all aspects of its operations.
- **Management deed/investment advisory deed** – appoints the manager and, if applicable, the investment advisor.
- **Subscription deeds** – completed by prospective investors and sets out their commitment to the fund and relevant representations and warranties.
- **Board minutes** – the manager and other entities in the structure will hold board meetings to approve their entry into the relevant legal documentation, the admission of investors and other relevant matters.
- **Legal opinions** – provided by the fund's legal counsel to investors and relate to issues such as the investors' limited liability and the due establishment of the partnership.
- **Side letters** – set out agreements with individual investors. Some funds may have "Most Favoured Nation" provisions which oblige the manager or general partner to offer to all investors any preferential terms or arrangements which any side letter confers upon an individual investor.

In order to ensure that the fundraising is not delayed, this documentation must be available for review by investors and their lawyers when requested. It must be produced to a high standard of quality, reflect the terms of the fund and provide appropriate protections for the manager as well as the investors.

We have developed an integrated suite of market tested documentation which we tailor to suit the needs of each client. In this way, we provide the best of both worlds – the efficiency and reliability of documentation that is tested in the marketplace together with the benefits of documentation that has been specifically tailored to suit individual fundraisings.

2.8 Negotiations and closing

Negotiations

Typically the terms of the fund together with the details of the legal documentation are carefully negotiated by investors, particularly “cornerstone” investors making a large, early commitment to the fund and whose participation is vital to the successful launch of the fund. These negotiations are reflected in amendments to the limited partnership deed (or equivalent document) and in side letters that are entered into with individual investors.

The negotiation process is often complex and intense as it involves simultaneous discussions with all of the investors who are participating in a particular closing. It is at this stage that the fundraising is dependant on the timeliness of investors as well as the manager and its advisers. However, prompt resolution of investor negotiations can significantly shorten the time to closing a fund and effective negotiations are crucial to ensuring that the manager secures the most advantageous terms in light of market practice.

In addition to the respective commercial bargaining powers of the manager and the investors, the success of these negotiations will depend on:

- a detailed knowledge of current market practice;
- an understanding of the relevant issues and how they have been previously addressed;
- an ability to think creatively about new solutions; and
- project management and co-ordination,

together these factors will help to ensure that the closing of a fund is not delayed or unnecessary concessions made.

The Simmons & Simmons investment funds team has wide experience of negotiating with investors in these matters. We have negotiated with investors from around the world investing into private funds and we are familiar with the issues typically raised and the ways in which they have been resolved previously. We are also experienced in managing the negotiation process. We will agree with you upfront how the negotiations are to be conducted and the level of your involvement. We will maintain and regularly update a matrix of investor comments together with our suggested responses. This will allow you to identify the key investor issues and respond to them quickly and efficiently. We then respond to investors and prepare updated documents without delay.

Establishment of entities

The structure of the fund will consist of a number of entities (see Section 2.2). Those that are specific to the fund, for example, in a limited partnership structure this is typically the limited partnership and its general partner, must be established prior to the first closing.

In addition, in the case of a first time fund, it is necessary to establish a suitably authorised entity to manage the fund (see Section 3.6 for more information). This must generally be done early in the fundraising process to ensure that the necessary regulatory authorisations have been obtained before it is required to engage in any regulated activities.

Closing

Each closing involves prospective investors submitting subscription deeds together with supporting documentation required under applicable anti-money laundering requirements. Once that

documentation has been reviewed, the manager will generally hold a board meeting at which it resolves to accept the subscription deeds and any relevant filings are then made with regulators.

We will review subscription deeds from investors and resolve outstanding issues. We aim to respond to investors on their subscription deeds within 24 hours. We have prepared a subscription deed designed to obtain the appropriate representations and warranties from investors while minimising confusion and delays on the part of investors. They are suitable for investors in all major jurisdictions including the United Kingdom and United States.

We will then prepare all the necessary documents for closing (or liaise with offshore counsel where relevant) and assist with a closing process that minimises delay and disruption.

2.9 Ongoing support

The final closing of a fund may mark the end of its establishment but it is just the beginning of the fund's life. At Simmons & Simmons, we are focussed on building mutually beneficial, long lasting relationships with our clients. Our post-closing role typically involves some or all of the following:

- **Bibles** – once the fund is closed, we will prepare comprehensive bibles of the fund documentation (including on CD) for you and individual bibles for each investor and distribute them without delay.
- **Fund compliance manual** – ensuring compliance with all of a fund's obligations can be time consuming and any failure to do so risks breaching agreements with investors that creates both reputational and legal risks. Simmons & Simmons can provide you with an integrated manual that brings together the fund documentation including side letters with individual investors and clearly sets out in one place all of the relevant obligations. This simplifies the investment process by consolidating all relevant restrictions on investments as well as ongoing tasks such as reporting by identifying any obligations that apply to individual investors.
- **Transfers** – we can advise on and document any transfers of interests in funds so that the manager, the fund and the other investors are appropriately protected.
- **Amendments to fund documents** – where it becomes necessary to amend the terms of a fund, we can advise you on the process that needs to be followed, prepare relevant documentation and, where the consent of investors is required, assist in discussions and negotiations with them.
- **Advice on fund documents** – we are always ready to provide speedy advice on the interpretation of fund documents throughout the life of a fund and to assist managers in continuing to achieve their commercial goals in accordance with the fund's governing documents.
- **Transaction support** – our international transactional team works closely with our funds lawyers to provide dedicated transactional support on investments, restructurings and exits.



3

Establishing a fund management business

A private fund will typically appoint a manager who will have day to day responsibility for the operation of the fund including the acquisition, management and disposal of its assets. The manager will generally be the principal entity through which the fund management business operates and will be the entity that undertakes tasks such as employing staff and leasing premises. However, depending on the precise structure there may instead be an offshore manager or general partner which receives advice from an onshore investment advisor.

The manager will be owned wholly or partially by the executives that are establishing the fund management business. While it is normal practice to establish new vehicles for each fund (e.g. a new limited partnership and a new company to serve as the general partner of that partnership), generally the same entity can be the manager of a number of different funds.

3.1 Spin-outs and start-ups – strategic partners

Where a new business is being established, as opposed to an existing business diversifying into fund management, support may be provided by a strategic partner (such as a former employer or an investor who is well known to one or more of the executives) who may provide some or all of the following:

- working capital to assist with the establishment of the business;
- assistance with the promotion of the fund;
- a “cornerstone” investment into the fund.

Any such support (particularly from an organisation that is well known in the relevant asset class) can also add significantly to the credibility of the business. Such assistance will generally be provided in return for some or all of the following:

- partial ownership of the fund management business;
- a share of carried interest/performance fees or management fees generated by the first fund (and possibly successor funds);
- a right to invest in one or more funds on favourable terms (e.g. reduced management fees or carried interest/performance fees).

Sufficient working capital (and possibly regulatory capital) will be required to operate the business up until the first closing of its first fund. A manager of a private fund will normally only start to generate income once a first closing has taken place when it will start to receive a management fee. To the extent that it is not provided by a strategic partner, the initial working capital will normally be provided personally by the executives who are establishing the business or by other participants.

3.2 Spin-outs and start-ups - name and intellectual property issues

When deciding on a name for the business, it is advisable to check if the name the business is proposing to use has been registered as a trademark by another person. If the name is available, it is advisable to take steps to protect the name as a trademark and to take steps to protect any other related intellectual property the business may use, such as domain names.

3.3 Spin-outs and start-ups – employment and solicitation issues

If some or all of the executives of the proposed manager are or have recently been employed by another fund management organisation, a number of potential issues must be handled carefully and sensitively. This is particularly relevant where the new business will be a competitor to the former employer as this may prompt the former employer to take action to protect its interests.

Issues to be addressed include:

- **Employment issues** – contracts of employment must be reviewed for matters such as notice periods and good and bad leaver provisions that apply to any carried interest or bonuses. Employment lawyers should be consulted to determine if the provisions of the Transfer of Undertakings (Protection of Employment) Regulations 2006 will apply.
- **Solicitation of employees** – identify and consider any restrictive covenants which apply to recruiting former colleagues.
- **Solicitation of investors** – identify and consider any restrictive covenants on promoting to and soliciting investors who participated in funds managed by previous employers. The use of a placement agent may assist in these situations.
- **Track record** – in the absence of any agreement to the contrary, employees will generally have no right to the use of track record information relating to investment performance from their previous employment which is likely to involve the use of confidential information. However, such information can generally still be used to the extent that it can be reconstructed from publicly available information.

We have advised on investment management start-ups and spin-outs over many years and this means that our financial services and employment groups have considerable experience of advising on these and related issues and can provide practical solutions which aim to eliminate or manage these risks.

3.4 Structure

New or existing entity

Where fund management is a new activity for an existing business, consideration must be given as to whether to form a new entity to carry out this business or whether an existing regulated entity is suitable. For example, it may be possible to make use of an existing regulatory authorisation (see below in relation to changes to existing authorisations).

Type of entity

The manager will normally be established in the jurisdiction where the majority of the executives are resident. Generally, the manager is established as either a limited company of which the executives are directors and shareholders or a limited liability partnership (LLP), or equivalent entity depending on the particular jurisdiction, of which the executives are members (i.e. partners). It is important to make the correct decision initially as a subsequent conversion between, for example, a limited company and a limited liability partnership can be time consuming and costly.

Tax efficiency

The form and structure for the manager should be tax efficient so as to maximise the receipt by the executives of the profits that the business generates as well as minimising income tax, capital gains tax, social security payments and VAT. An important consideration for the structure of the manager is the taxation status of the executives. For example, where are they resident for tax purposes? If they are resident in the UK, are they UK domiciled or non-domiciled? Are they subject to US tax?

The management of a fund can generate profits in two distinct ways. The first way is through carried interest/performance fees which are typically received by a separate entity, often called the “carry partnership”, which is set up specifically for each fund, and are then distributed amongst the individual executives. The considerations set out above will also be relevant in structuring the receipt of this carried interest/performance fees. The second way is through different types of fees charged by the manager:

- **Fund management fees** (fees charged by the manager to the fund) – these are usually calculated as a percentage of total commitments during the investment period and subsequently as a percentage of the amount of commitments drawn down to acquire investments (excluding those which have been disposed of or written off). The intention is that these should cover the manager’s overheads, for example, salaries and rent. However, to the extent that they are in excess of the manager’s overheads, they may also generate profits. This is more likely to occur when the manager is simultaneously managing a number of funds.
- **Transaction fees** (fees charged by the manager to portfolio companies in which the fund has invested, for example, arrangement fees or directors’ fees) – a manager, depending on the terms of the fund, may be entitled to retain a share of the transaction fees generated in relation to the investments made by the fund.
- **Miscellaneous fees** (fees charged by the manager to other clients) – the manager may receive fees for advisory or other work unrelated to management of a particular fund, for example, for managing separate accounts for clients. The manager should be permitted under the terms of each of the funds that it manages to retain such amounts.

The way in which any profits are distributed to executives will depend on the structure chosen for the manager. If it is established as a company, the executives will be employees/shareholders and will receive a salary and bonus or dividends. If it is structured as a limited liability partnership (or equivalent), and they are partners in that partnership, they will receive a profit share. Often hybrid arrangements may be possible to maximise tax efficiency.

Distributing a profit share to the executives rather than paying the executives a salary/bonus or dividends is generally more tax efficient and should reduce any liability to make social security payments. However, this advantage will only apply to executives who are partners in the LLP (who will not have the same rights as an employee) and not to those staff who are retained as employees. This tax efficiency generally makes a limited liability partnership a more attractive structure for UK based executives than a limited company.

Establishing subsidiaries/branches

Depending on the scale of the new business, the manager may consider establishing additional offices outside its home country either initially or at a later time. These offices can be established either as new entities (typically subsidiaries of the manager) or as branches of the manager (so that no new legal entity is formed).

Where the manager is established in the European Economic Area and needs to obtain some form of regulatory authorisation (see Section 3.6), it will sometimes be preferable to establish additional offices which are also in the European Economic Area as branches because the manager's existing authorisations in its home country can sometimes be "passported" into the new country thus avoiding the need to obtain different authorisations in each country in which an office is established.

Exit and succession planning

While it is easy to focus on the issues associated with the establishment of a new fund management business, at the same time thought must be given as to how the executives can exit from that business in the future. Is the structure suitable for sale of the business? For example, a strategic partner may eventually wish to acquire the business. Can individual executives exit through a sale of their interest in the business to other executives? If so, on what terms? Is there adequate flexibility to allow new executives to enter the business as it expands? Can an exit be achieved tax efficiently?

A limited liability partnership structure should not raise difficulties if a sale of the business is contemplated although (at least in the UK) it is not suitable if a stock exchange listing is the preferred exit route. A limited company is suitable for either a sale or a listing although (as discussed above) it may not be as tax advantageous on an ongoing basis.

Simmons & Simmons has advised on the establishment of numerous new fund management businesses. Our experience in this area allows us to provide practical, comprehensive advice on a cost effective basis. We have developed a comprehensive suite of documentation relating to the establishment of a fund management business (both as a limited company or as a limited liability partnership) in order to be able to establish these entities efficiently and without delay.

3.5 Documentation

Once the preferred structure of the manager has been decided, the next step is to prepare the relevant documentation (e.g. the memorandum and articles of association and shareholders agreement in the case of a company or the partnership deed in the case of a limited liability partnership) and establish the entity.

Prior to or at this point the executives must determine in more detail how the relationship between them will be governed, and how the manager will operate (e.g. governance, sharing of profits, admission of new members and resignation or removal of existing members). A more detailed list of the issues which must be addressed is set out in the Questionnaire in Section 4.

With our experience of establishing fund management businesses we are well placed to advise you on the types of issues that commonly arise and the different practical solutions that can be adopted.

3.6 Regulation

The operation and management of a private fund is an activity that is regulated in the vast majority of jurisdictions (including throughout the European Union). Therefore, some form of authorisation from a regulatory authority (such as the FSA in the UK) is typically required before the manager can engage in certain activities.

While the precise regulation in each jurisdiction varies, we have set out below some common principles that apply across many of the jurisdictions in which the managers of private funds operate.

What activities are regulated?

Generally three types of activities relevant to the establishment, operation and management of private funds are subject to regulation:

- **Marketing** – the marketing and promotion of the fund to investors including arranging for those investors to participate in the fund;
- **Operation** – the day to day activity of operating and managing the fund including safeguarding the assets of the fund; and
- **Investments** – managing, advising on, arranging and dealing in the investments which the fund makes (e.g., in the case of a private equity fund, the shares in portfolio companies), including arranging for third parties to participate in syndicate deals.

In relation to marketing, the use of a placement agent who is authorised in one or more of the jurisdictions in which the fund is being marketed may assist.

Regulatory authorities will generally divide investors who are provided with financial services into two or more categories. Retail investors (including ordinary individuals) are usually categorised separately from more sophisticated investors such as financial institutions, corporations and “sophisticated” individuals who have the experience, net wealth or income to justify a lighter touch regulatory approach. With few exceptions, private funds are marketed only to this second category of more sophisticated investors as the regulatory obligations associated with promoting funds to them and

operating and managing funds in which they invest are significantly less onerous than those that would apply to retail investors. Understandably, the manager owes a much higher duty of care to retail investors.

Is regulation always required?

In some offshore jurisdictions there may be sufficient exemptions to allow a manager to operate and manage private funds without obtaining any form of authorisation. However, this generally limits the activities of the manager significantly, for example, it may limit the ability of the manager to promote the funds which it manages and may prevent it from being able to syndicate transactions. Also, an unregulated manager may be a concern for potential investors.

Getting regulated – the application process

The process for obtaining the necessary authorisation varies depending on the particular regulator but it will generally involve submitting an application containing the following types of information:

- **Activities** – the exact scope of the authorisations which are being sought;
- **Business and financial plan** – a regulatory business plan for the manager, including a financial budget that supports the plan;
- **Ownership** – a description of the ownership structure of the manager;
- **Governance** – a description of the manager’s internal decision making and compliance arrangements; and
- **Key personnel** – information on the relevant experience of those executives who will be responsible for carrying on the regulated activities of the manager. (Note that at least in the UK, where the manager’s clients do not include retail investors, there is no requirement for these executives to hold particular qualifications or pass specific exams).

While it may be possible to engage in certain promotional activities in relation to a first fundraising prior to obtaining the relevant authorisation, it will be critical to ensure that an application is lodged in sufficient time so that the application process does not impede the fundraising.

As part of its authorisation, the manager may be required (e.g. this is the case in the UK) to maintain a minimum amount of regulatory capital. The amount will need to be determined and the manager will need to ensure that it has access to and can maintain this capital in the future.

Once the relevant authorisation has been obtained, the manager will need to ensure that it complies with the relevant ongoing regulatory requirements.

3.7 Change of authorisations

Where fund management is an extension of an existing regulated business, such as a boutique corporate finance advisory business, it may be possible to make use of an existing authorisation by amending it so that it covers all the activities relevant to fund management. This will reduce the time, cost and effort required compared to seeking an entirely new authorisation.

We can assist in identifying the relevant authorisation that you require (or any variation to an existing authorisation) and work with you to ensure that your regulatory application is handled quickly and with minimal disruption. We will discuss with you the level of our involvement. We usually suggest that you work with a compliance consultant on the detailed aspects of the application process.

3.8 Using another firm's authorisation

It is possible for a manager to operate under the regulatory umbrella of another authorised firm as a tied agent/appointed representative. The advantage of these arrangements are that they can be put in place more quickly, but they do limit the scope of the manager's operations and business. Some managers acquire these services on a commercial basis, whilst others may do so through a spin-out relationship.

3.9 The European Directive on Alternative Investment Fund Managers

In April 2009, the European Commission published a proposal for a European Directive on Alternative Investment Fund Managers (the "AIFM Directive") the final text of which was adopted by the European Parliament on 11 November 2010. Formal approval of the Directive by the European Council is expected shortly. It is currently anticipated that the member states of the European Union will have until approximately May/June 2013 to transpose the provisions of the AIFM Directive into their national laws.

Broadly, the objectives of the AIFM Directive are to control systemic risks, ensure appropriate investor protection and appropriate transparency within the Alternative Investment industry by imposing a number of obligations on the managers of Alternative Investment Funds ("AIF"). Many private fund managers will be considered managers of AIFs and will be subject to the provisions of the AIFM Directive. The practical implications of the AIFM Directive for private fund managers will depend to a large extent on the level 2 implementing measures which are to be formulated as part of the transposition of the AIFM Directive into national law. As part of the establishment of a fund management business, new managers should seek advice on what particular actions will need to be considered as a result of the AIFM Directive. We will be monitoring the development of the level 2 implementation process and keeping our clients updated on its progress and the specific considerations that new and existing private fund management businesses should be aware of.



4

Questionnaire

Set out below is a list of the initial questions that are relevant to a first time fundraising and the establishment of a fund management business. Many of these are discussed in more detail in Section 2, 'Fundraising' and Section 3, 'Establishing a fund management business'.

4.1 Fundraising

- **Target assets** – What type of assets is the fund intending to acquire and where are they located? Is the fund intending to acquire a seed portfolio or any warehoused assets?
- **Target investors** – Who are the target investors and where are they located?
- **Management team** – Who are the key people who will be managing the fund? Where are they resident?
- **Type of fund** – Will the fund be a blind pool fund or pledge fund?
- **Fund size** – What is the target size of the fund?
- **Placement agent** – Will a placement agent be appointed and on what terms will it be engaged?
- **Carried interest/performance fees** – Who will have a share in the carried interest/performance fees?
- **Timing** – When is it envisaged that the fund will be launched/first closing take place?
- **General partner's commitment** – How much will the management team commit to the fund?
- **Administrator, auditors and other services providers** – Who will the administrator and auditors be? What other service providers will be appointed and on what terms are they being engaged?

4.2 Establishing a fund management business

- **Manager** – Will an existing entity be used as the manager or will a new one be formed? Where will it be established? Will it have any branches in other countries?
- **Strategic partner** – Does the manager have a strategic partner? If so what support will it provide and what will it require in return?

- **Regulatory** – Is there an existing regulatory authorisation? Or will a newly authorised entity be required?
- **Employment** – If spinning out from a former employer, what issues arise as a result of previous employment contracts? For example, notice periods, good and bad leaver provisions relating to bonuses and carried interest.
- **Restrictive covenants** – If spinning out from a former employer, what restrictive covenants apply to the recruitment of former colleagues or to the promotion of the fund to investors?
- **Track record** – If spinning out from a former employer, what restrictions are there on the use of track record information? To what extent can it be reconstructed from publicly available information?
- **Capital contributions** – How much capital will the shareholders/members of the manager contribute? Will there be any obligation to contribute additional amounts/make loans in the future?
- **Profit sharing** – How will profits be split between the shareholders/members of the manager?
- **Governance** – How will decisions about the operation of the manager be made? Will all members/shareholders be involved in all aspects of decision making or will some of them be given responsibility for day to day decisions while other matters will require the approval of all of them?
- **Premises/staff** – Does the manager need to obtain suitable premises? If so, where and on what terms? Does it require additional staff, if so what positions will need to be filled, on what terms will they be employed and when will those people be required?
- **Admission/removal of members** – Will new members/shareholders be admitted? On what grounds could they be removed? On what terms would their admission/removal take place?
- **Administration arrangements** – book keeping/management accounts, employment taxes, corporate taxes, regulatory reporting, IT support, HR policies and audit arrangements.
- **Compliance arrangements** – establishing compliance infrastructure and putting in place compliance oversight reporting.
- **Transfers** – Will members/shareholders be able to transfer their interests in the business? If so, on what terms and will there be pre-emptive or other similar rights that will apply?
- **Covenants** – Will the members/shareholders give any covenants, for example, about the amount of time that they will devote to the business or that they will not participate in a competing business?



5

Managing costs

Simmons & Simmons recognises that managing legal costs is important for any fund raising, whether it is a start-up/spin-out, a debut fund for an existing organisation or is sponsored by an established fund manager. Legal costs, together with the other costs of a fundraising, typically form part of the organisational costs that are borne by the fund (up to a cap) following its first closing and are not borne by the manager. The organisational costs that are borne by the fund sometimes also include the costs of establishing the manager.

We have developed a number of techniques that we can use to help you manage the costs of a fundraising:

- **Staged documentation** – We can prepare and/or review initially only those documents necessary to promote the fund, such as the private placement memorandum and other marketing documents such as a one pager and road show presentation. This means the costs of drafting detailed legal documentation are not incurred until the manager is confident that there is sufficient interest from investors to justify proceeding. Our integrated suite of documentation allows us to prepare the legal documentation at this later stage without delaying the fundraising.
- **Abort/uplift** – We recognise that there may be uncertainty as to whether a fundraising will proceed, therefore, we are happy to negotiate on a case by case basis arrangements under which our fees are reduced in the event that a fundraising does not proceed to closing with a corresponding uplift in the event that the fundraising is successful. This also creates a strong alignment of interests with the manager.
- **Transactional work** – As a full service provider, we are able to provide both fund formation and transactional services. We would be happy to discuss a reduction in overall legal costs where a fund manager retains us for both fund formation and subsequent transactional work.
- **Timing** – As legal costs relating to the fund's establishment are typically borne by the fund, we can assist the manager's cash flow by delaying the billing of our costs until the first closing of the fund (on the basis that our bill is paid within an agreed timeframe).

We are flexible and innovative in structuring our fee arrangements and are happy to discuss these and other options with you.



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Why Simmons & Simmons?

Our international private equity team has the experience, industry knowledge and legal skills to advise clients across a wide spectrum of industry sectors. With a particular focus on financial institutions, technology & media, energy & infrastructure and life sciences, we are able to put our legal advice in context. We are also proud to be a strategic partner of the BVCA in providing training and advice on the establishment of new private fund management entities and the launch of their debut funds through its annual workshop for first-time fund managers.

Private funds work often requires skills in specialist areas and we are supported by our leading tax, employment, acquisition finance, competition, regulatory and IP teams.

'Legal firm of the year'

Global Investor Awards 2010

Our team is:

- **Trusted** – we are the BVCA's strategic partner in providing training on the establishment of new private fund management entities and the launch of their debut funds through its annual workshop for first-time fund managers.
- **Efficient** – We are dedicated to helping you design, market, implement and close your fund in the shortest possible time so that legal issues and documentation do not slow down your fundraising. We will prepare and agree with you a timetable for the fund raising process.
- **Commercial** – We provide advice and draft documentation that is commercially focussed with the objective of securing the most advantageous terms for the manager in light of market conditions. We are fully up-to-date on the latest market developments and can advise on the most appropriate fund terms.
- **Experienced** – The partners and associates in our team are dedicated to private fund formation, they are highly experienced in establishing funds for UK and non-UK independent and institutional managers. We agree with you upfront the partners and senior lawyers who will work on a day to day basis on your fundraising.
- **Recognised** – We are recognised by the UK and international legal directories as being one of the leading firms in the private funds sector.
- **Integrated** – Our funds practice is also fully integrated with our transactional practices in the UK and internationally in order to provide a complete service, from fund formation to portfolio investment acquisition, to refinancing/ restructurings and divestment.

'European legal adviser of the year'

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