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Funds Bulletin

Hogan Lovells

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1. Global and EU Developments

1.1 EuSEF and EuVECA Regulations - European Commission's review

The European Commission has been reviewing the EU Social Entrepreneurship Funds and the EU Venture Capital Funds Regulations in order to improve the uptake of these funds. Proposed amendments include:

- removal of the minimum investment limit, which is currently EUR 100,000 (in order to increase the investor base);
- allowing authorised AIFMs to manage EuSEFs and EuVECAs. Currently, only sub-threshold AIFMs are able to manage EuSEFs and EuVECAs. The consultation has now closed and a response paper is due from the Commission.

1.2 UCITS Directive - ESMA's consolidated Q&As

The European Securities and Markets Authority (ESMA) has published a new Q&A document on the application of the UCITS Directive, as amended.

The document includes new questions about the additional documentation that are required in relation to the remuneration and depositary requirements of UCITS V. It also repeals and replaces four Q&A on UCITS that ESMA has previously issued.

1.3 Closet index tracking - ESMA statement on supervisory work

ESMA has published a statement on its supervisory work in relation to "closet index tracking" (ie when a fund is claimed to be actively managed but in reality stays close to a benchmark). According to ESMA, 5-15% of UCITS are potentially closet index trackers.

1.4 MiFID II will not come into effect until January 2018

The Commission has announced that the revised Markets in Financial Instruments Directive and Regulation (known as MiFID II) will not come into effect until January 2018.

The reason for the extension is the complex IT infrastructure that is required to be in place under MiFID II. ESMA has to collect data from about 300 trading venues on about 15 million financial instruments. To achieve this result, ESMA must work closely with national competent authorities and the trading venues themselves. However, ESMA has said that neither competent authorities, nor market participants, would have the necessary systems ready by 3 January 2017 (when MiFID II was initially scheduled to become operational).

Further MiFID II developments will be set out in our weekly Financial Institutions Group bulletin (please click here for subscriptions).

1.5 Market Abuse Regulation (MAR): ESMA consults on guidelines

ESMA has published a consultation paper on draft guidelines clarifying the implementation of the Market Abuse Regulation (MAR). MAR will apply directly in EU Member States from 3 July 2016, amending the previous Market Abuse Directive.

ESMA is seeking feedback on the draft guidelines:

- from **investors receiving market soundings** (ie information before the announcement of a transaction, in order to gauge their interest in a possible transaction), including the factors for them to assess whether the information they receive amounts to inside information, the steps to take if inside information has been disclosed to them and the records to maintain in order to demonstrate such compliance; and
- on legitimate interests of **issuers to delay disclosure** of inside information and on situations in which the delay of disclosure is likely to mislead the public.

Comments are requested by 31 March 2016.

Various parts of the UK regulatory and legal system will change as a result of MAR. FCA Handbook and the AIM rules must be made compatible with MAR and the Handbook will contain guidance on matters covered by MAR (but MAR itself will include the rules). MAR will mainly have an impact on the following areas of the FCA Handbook:

Code of Market Conduct (to be preserved as far as possible), the Model Code (will change to guidance) and the Disclosure rules. The Financial Services and Markets Act will also change (see further our briefing).

Further MAR developments will be set out in our weekly Financial Institutions Group bulletin. Please click here for subscriptions.

1.6 European Commission call for evidence on the EU regulatory framework for financial services: HM Treasury and AIMA responses

HM Treasury has published the UK Government's response to the European Commission's September 2015 call for evidence on the EU regulatory framework for financial services, which it strongly supports.

The response provides an overview of the UK Government's main points, including the need for:

- synchronisation of reporting and disclosure requirements;
- uniformity of definitions;
- connecting legislation;
- regulatory proportionality.

The UK Government also considers that the follow issues merit sustained collective consideration:

- the long-term decline in market liquidity and its implications for market making and the efficiency of financing the real economy;
- building on the work done in the capital markets union on how financial services regulation can support long-term investment across the sector including banks, funds and insurers; and
- how best to support the openness of European and global markets as they adjust to new regulatory regimes.

AIMA has also responded and calls for rules to allow greater participation by asset managers in securitisations, which would provide non-bank finance to small and medium-sized enterprises (SMEs); please see full list of responses.

1.7 ESMA has published responses to the Consultation on PRIIPs Key Information Documents

ESMA has published responses to the Consultation of the Joint Committee of the European Supervisory Authorities (ESAs) on packaged retail and insurance-based investment products (PRIIPs) Key Information Documents (KIDs).

2. UK DEVELOPMENTS

2.1 FCA policy statement on implementing UCITS V

The FCA has published a policy statement on the UK implementation of the UCITS V Directive, including final rules and Handbook changes, which affect managers and depositaries of UCITS and alternative investment funds (AIFs). The final rules are set out in the UCITS V Directive Instrument 2016 (FCA 2016/4) and will come into force on 18 March 2016 (that is, the date by which UCITS V must be implemented). There are also transitional provisions applying to some of the final requirements, which run for up to two years, starting from 18 March 2016.

The intention of UCITS V is broadly to bring the UCITS depositary and remuneration rules in line with the Alternative Investment Fund Managers Directive (AIFMD) and it also sets out new rules about sanctions. The majority of Handbook changes relate to UCITS managers (including a new UCITS Remuneration Code and transparency requirements) and their depositaries (for example new eligibility criteria and capital requirements). However, there is also a clarification that applies to depositaries of AIFs that makes it clear that a depositary may delegate supporting administrative or technical tasks linked to its depositary function (FUND 3.11.26).

The FCA is aware of the mismatch between the time when the UCITS V requirements come into force and when the Level 2 Regulation will become applicable to firms. During this period, firms are expected to make efforts to comply with the UCITS V requirements as of 18 March 2016 (unless a relevant transitional provision applies).

In addition, once ESMA has finalised its UCITS V remuneration guidelines, the FCA will consider whether further guidance is needed on applying the UCITS Remuneration Code. If so, the FCA will consult on this.

2.2 Register of persons with significant control (PSC Register)

From 6 April 2016, UK companies, UK registered limited liability partnerships (LLPs) and societates europaeae (SEs) (ie public companies registered in accordance with the Council Regulation on the Statute for a European Company, which can more easily transfer to, or merge with companies in, other EU member states) will be required to maintain a register of persons with significant control over them (PSC register); see further our client briefing.

Note that companies are exempt if they have shares traded on any of certain specified markets, including the LSE's main market and AIM.

The Department for Business, Innovation & Skills (BIS) has published guidance on the meaning of significant influence or control and guidance on the significant control register. Draft Limited Liability Partnerships (Register of People with Significant Control) Regulations 2016 have been published.

2.3 Innovative Finance ISA and the regulated activity of advising on peer-to-peer agreements: handbook changes

Further to FCA's discussion paper, DP15/6,the following legislative changes are proposed by HM Revenue and Customs and HM Treasury to take account of legislative developments that will impact the regulated loan-based crowdfunding sector:

- the Individual Savings Accounts Regulations 1998 (ISA Regulations) will be amended to allow peer-to-peer (P2P) agreements (also known as article 36H agreements) to be held in an Individual Savings Account (ISA) wrapper, in a new component to be known as an Innovative Finance ISA (IFISA) (available from 6 April 2016);
- the Regulated Activities Order (RAO) will be amended to make advising on P2P agreements (article 36H agreements) a regulated activity (RAO article 53(2)).

A draft version of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2016 containing these changes has been published. The FCA has also published a consultation paper, CP16/5, which consults on proposed changes to its Handbook to reflect the introduction of the IFISA and the new regulated activity of advising on P2P agreements.

The FCA is aiming to publish a policy statement making final rules in March 2016, in time for the introduction of the IFISA and new regulated activity on 6 April 2016.

2.4 Benchmark Regulation: FCA Questionnaire and speech

The FCA has published a questionnaire on managers with UCITS or AIFs which use an index as their benchmark.

Edwin Schooling Latter, the FCA's Head of Markets Policy, has given a speech on the proposed Benchmark Regulation and its impact on the UK. This Regulation will supersede the UK’s existing rules, which are covered in chapter 8 of the Market Conduct sourcebook, and affect a wider set of firms than the current rules. These can be divided into three main groups: benchmark administrators, contributors and users.

2.5 UK and China Asset Management Collaboration

The UK Trade & Investment (UKTI) China Financial and Professional Services Team is currently working with the Asset Management Association of China (AMAC) to develop a bilateral forum for long-term strategic collaboration between the UK and China asset management industries. The forum will discuss inter alia, distribution challenges, access to competent regulators and potential collaborative structures.

3. EU AND GLOBAL TAX DEVELOPMENTS

3.1 OECD tax transparency deal receives international agreement

Accountancy Age reports that 31 countries agreed to sign an OECD agreement on tax co-operation, enabling the sharing of country-by-country reports. Amongst others, the UK, France, Germany, Luxembourg and Ireland signed up to the Multilateral Competent Authority Agreement.

The agreement has the goal of giving tax authorities a *"complete understanding of the way multinational corporations' structure their operations"*. They will receive aggregate information from multinationals annually, starting with their 2016 accounts. The countries involved will then be able to exchange information from 2017. Country-by-country reporting will also force companies to reveal information about the jurisdictions they do business in and the business activities each entity engages in.

"Country-by-country reporting will have an immediate impact in boosting international co-operation on tax issues, by enhancing the transparency of multinational enterprises' operations," said OECD secretary-general Angel Gurría.

"Under this multilateral agreement, information will be exchanged between tax administrations, giving them a single, global picture on the key indicators of multinational businesses. This is a much-needed tool towards the goal of ensuring that companies pay their fair share of tax, and would not have been possible without the BEPS Project."

3.2 European Commission presents anti-tax avoidance package

The European Commission has published a new anti-tax avoidance package. The aim of the package is for the 28 EU member states to combat aggressive tax practices by large companies through coordinating and implementing international standards against base erosion and profit shifting.

Key features of the new proposals include:

- legally-binding measures to block the most common methods used by companies to avoid paying tax;
- a recommendation to Member States on how to prevent tax treaty abuse;
- a proposal for Member States to share tax-related information on multinationals operating in the EU;
- actions to promote tax good governance internationally;
- a new EU process for listing third countries that refuse to play fair.

The package is based around the three core pillars of the Commission's agenda for fairer taxation:

- Ensuring effective taxation in the EU so that companies pay tax where they make their profits. An anti-tax avoidance directive is proposed with recommendations on tax treaties.
- Increasing tax transparency to ensure fair tax competition. A revision of the Administrative Cooperation Directive is proposed. The aim is to improve the exchange of tax related information on multinational companies' activities.
- Securing a level playing field. The package includes a Communication on an External Strategy for Effective Taxation. It calls for cooperation with the EU's international partners and implementation of international standards.

The two legislative proposals of the Package will be submitted to the European Parliament for consultation and to the Council for adoption. The Council and Parliament should also endorse the Tax Treaties Recommendation and Member States should follow it when revising their tax treaties. Member States should also formally agree on the new External Strategy and decide on how to take it forward as quickly as possible once it has been endorsed by the European Parliament.

4. UK Tax Developments

4.1 Carried interest: draft Finance Bill legislation

The Alternative Investment Management Association (AIMA) has responded to the draft Finance Bill legislation regarding income-based carried interest received by UK investment managers.

The draft legislation limits the circumstances in which amounts of carried interest received by individuals are taxable as capital gains. AIMA and the Alternative Credit Council wish to incorporate amendments to an exclusion relating to “direct lending funds” in order to improve the technical rules and more closely reflect the economic reality of the private debt space.

5. US Tax Developments

5.1 Treasury Released Fiscal Year 2017 Revenue Proposals

On February 9th, the U.S. Treasury released the General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals. There are approximately 145 separate revenue proposals in the president’s FY 2017 budget release. Many of the proposals are aimed at reforming the U.S. International Tax System and are similar to those in last year’s budget. Some relevant proposals are summarized as follows:

(a) Taxing Gain from the Sale of a Partnership Interest on Look-Through Basis

Currently, there is ambiguity in whether the gain non-resident alien individuals and foreign corporations realize from the sale of a partnership interest is subject to federal income tax when the partnership earns income effectively connected with the conduct of a US trade or business (“ECI”). The proposal would explicitly provide that such gain is ECI to the extent attributable to the transferor partner’s distributive share of the partnership’s unrealized gain or loss that is attributable to the ECI generating property. Additionally, the transferee of a partnership interest would be required to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certified it was not a non-resident alien individual or foreign corporation.

(b) Restricting the Use of Hybrid Arrangements that Create “Stateless Income”

The proposal would deny deductions for interest and royalty payments made to related parties under certain tax planning circumstances involving a hybrid arrangement. This would apply, for example, if either (i) as a result of the hybrid arrangement, there is no corresponding inclusion to the recipient in the foreign jurisdiction or (ii) the hybrid arrangement would permit the taxpayer to claim an additional deduction for the same payment in another jurisdiction.

(c) Increasing the Capital Gains Rate

The proposal would increase the highest long-term capital gains and qualified dividend tax rate from 20% to 24.2%. Because the 3.8% net investment income tax would continue to apply as under current law, the maximum total capital gains and divided tax rate including net investment income tax would thus rise to 28%.

(d) Taxing Carried Interests as Ordinary Income

The administration once again proposed taxing carried interests as ordinary income, regardless of the character of the income at the partnership level, so that such income would not be eligible for the reduced rates that apply to long-term capital gains. The partner would also be required to pay self-employment taxes on such income. The proposal would also institute other “anti-abuse rules” designed to prevent the avoidance of the proposal through the use of compensatory arrangements other than partnership interests.

(e) Providing for Reciprocal Reporting of Information in Connection with FATCA

Under the proposal, certain financial institutions would be required to report the account balance for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal would also expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. The Secretary would also be granted authority to issue regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information determined to be necessary. The proposal also would require financial institutions that are required under FATCA or this proposal to report to the IRS information with respect to financial accounts to furnish a copy of the information to the account holders.

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