

Brexit: impacts and actions for listed funds



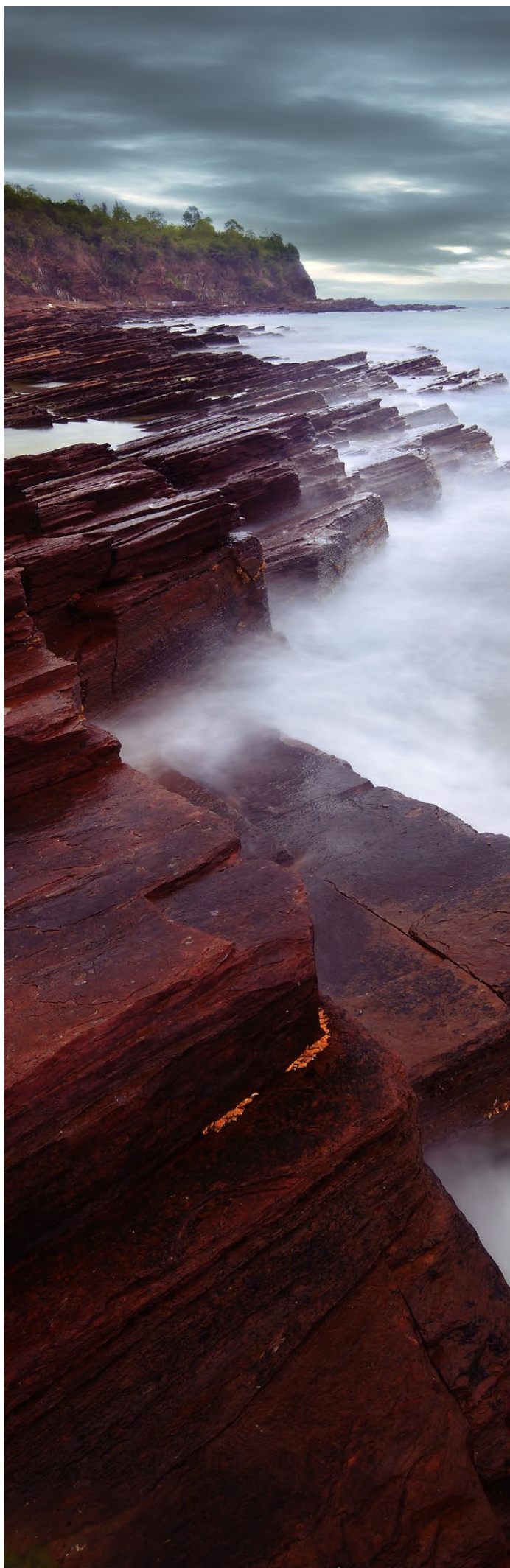
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Introduction

Listed funds¹ need to consider the impact of the result of the Brexit referendum on their operations. This is a responsibility of both the Board and also the AIFM (if different).

Boards and their managers need to assess the short, medium and longer term potential impacts of Brexit and develop strategies to manage these impacts.

The longer term impact of Brexit on listed funds will depend on the terms of the settlement between the UK and the EU which will govern the UK's post-Brexit relationship with the EU. Whilst the terms of Brexit are unclear, which makes long term planning challenging, there are a number of short and medium term actions that listed funds and their Boards should be taking.

This note discusses the potential Brexit impacts on listed funds and the actions that Boards and managers should take. It also sets out the laws and regulations that apply until Brexit, and looks at the range of possible post-Brexit models and their impact on listed funds.

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¹ This note is primarily focussed on investment companies whose shares are admitted to trading on the London Stock Exchange's Main Market for listed securities and subject to Chapter 15 of the UK Listing Authority's Listing Rules. However, many of the considerations in this paper are also relevant for closed-ended investment companies whose shares are admitted to trading on the London Stock Exchange's Specialist Fund Market, the Alternative Investment Market and other stock exchanges.

Context

Is Brexit inevitable?

Whilst the referendum result may provide a political mandate for Brexit, its legal status is only advisory and not binding. In addition, it provides no guidance about the form which the UK's future relationship with the EU and the rest of the world should take. The formal process for Brexit would also not start unless and until the UK delivers a notice under Article 50 of the Treaty on European Union. This would trigger a two year transitional period for withdrawal arrangements to be agreed, at the end of which (absent an agreed extension to the process) the UK would automatically leave the EU.

The difficulties inherent in agreeing the withdrawal arrangements in this time frame has already generated intense political discussion about when the UK should issue its Article 50 notice. Until it does so, Brexit is not inevitable; although politically it is highly likely.

When is Brexit likely to occur?

The two year clock to Brexit will not start until the UK delivers a notice under Article 50. There are a range of views on the procedure within the UK that needs to be followed before such notice can be served, including whether parliamentary approval is required. In practice, the UK is likely to want to negotiate exit, the new relationship with the EU and transitional arrangements

in parallel and before formally serving notice under Article 50; although whether EU Member States will engage in any form of negotiations before notice has been served remains to be seen. As such, Brexit is unlikely to occur much before 2019 at the earliest.

Business as usual for listed funds until Brexit?

EU laws and regulations currently in place or implemented before Brexit takes effect will still be binding on and in the UK until then (see further page 11 below). In the longer term, Brexit will mean an overhaul of the legal and regulatory environment in which listed funds operate. However, the most likely short term effects of the result of the Brexit referendum on listed funds will be economic, rather than legal or regulatory.

Changes in the value of sterling, inflation, interest rates, yields on gilts and corporate bonds, property values, rises and falls in the stock market and increased market uncertainty leading to volatility will impact listed funds in a variety of ways. The post-referendum economic environment will provide challenges, risks and opportunities for listed funds. The performance of underlying portfolios and the ability of listed funds to raise money in both the debt and equity capital markets are likely to be affected.



What do listed funds need to do, and when?

Boards and their managers need to assess the short, medium and longer term potential impacts of Brexit and develop strategies to manage these impacts. Key elements of Brexit planning to be considered include:

- assessing implications for pending transactions, material contracts and investment mandates, in the short, medium and longer term;
- devising a communication strategy on potential Brexit impacts, which balances market reassurance with suitable caution about Brexit's unknown impacts;
- preparing for market volatility and considering strategies to capitalise on opportunities, or mitigate adverse impacts;
- stress-testing ordinary course activities (such as tap issues, scrip dividends, buy-backs and valuations) by reference to a range of market conditions and scenarios;
- reassessing foreign exchange risks and if relevant updating currency hedging policies;
- preparing defensive strategies to deal with opportunistic corporate actions;
- analysing the shareholder register and formulating a strategy to ensure that the listed fund can still engage with and raise capital from EEA investors post-Brexit; and
- once the shape of Brexit becomes clearer, testing whether the current domicile continues to provide the optimum tax and regulatory treatment when balanced with the operating costs of the jurisdiction.

Listed funds will need to continue to adhere to currently applicable rules and guidance (even if they emanate from EU) and will need to continue with plans to implement the PRIIPs KID Regulation from 31 December 2016.

Immediate/short term actions

Listed funds need to consider whether there are any short term implications of the Brexit vote on their business, and if so, how they communicate this to the market. We discuss some of the possible short term implications and some considerations relating to market communications on page 7 below.

Medium term actions

Medium term actions focus on positioning the listed fund to deal with potential market volatility and other indirect impacts of the Brexit vote on day-to-day operations. We discuss some of these actions on pages 8 and 9 below.

Longer term actions

The longer term impact of Brexit on listed funds will depend on the terms of the settlement between the UK and the EU which will govern the UK's post-Brexit relationship with the EU. At this stage, no one knows the outcome of these negotiations; so this is an area that listed funds will need to monitor on an ongoing basis. We set out what we believe to be the potential post-Brexit UK-EU relationship models on page 13 below.

The impact on listed funds from the various models will depend on a fund by fund basis and will be driven by the extent to which the listed fund has cross-border activities into the EU. Listed funds that have a large continental European shareholder base or that have a non-UK, EU based investment manager are likely to need to look at the potential implications of the various different models and plan for these earlier than funds with predominantly domestic activities.

Short to medium term impacts on listed funds

Impact assessment and communications with shareholders and the market

Listed funds will need to consider the impact of the result of the Brexit referendum and whether this impact may constitute inside information that needs to be disclosed to the market.

The referendum result, the resultant market volatility and its impact on share price performance does not need to be disclosed (this is already public). However, listed funds need to assess whether there are any potential impacts that are not in the public domain that a reasonable investor would be likely to use in making investment decisions that may constitute inside information.

Particular care should be taken when issuing “business as usual” announcements to the market in view of the potentially unquantifiable and unknown consequences that Brexit may have and the (currently unknown) form that the UK’s post-Brexit relationship with the EU will take. Carefully worded communications that address the potential impacts on Brexit on a particular aspect of the listed fund’s business are likely to be fine as long as they are carefully considered and restricted in scope. Broad statements that Brexit will have little or no impact on a listed fund should be avoided. They are potentially actionable by shareholders suffering losses if they are subsequently shown to be both untrue and relied upon by a shareholder in making an investment decision.

The amendments to the market abuse regime that result from the EU Market Abuse Regulation (MAR) that came into force on 3 July 2016 are not affected by the Brexit vote. MAR includes (amongst other things) new prospective procedures to be followed when disclosing inside information for market sounding purposes.

Impact on material contracts

Many contracts to which listed funds, their AIFMs or their underlying investee companies are party include reference to a territory. Examples include territorial grant (e.g. appointment as placing agent or distributor in a particular territory), territorial scope (e.g. in a joint venture or an allocation policy) and territorial restrictions (e.g. exclusivity commitments, key person provisions, etc.).

Contracts affected will include many which relate to the grant of intellectual property (including software, trade mark and patent licences) and corporate transactions (including non-compete undertakings), as well as many commercial contracts (such as investment management agreements, placing agreements, distribution agreements, etc.). The key question is whether a reference to the EU, for example as the territory which is covered by the contract, in a contract signed pre-Brexit will be deemed to include or exclude UK with respect to a period after Brexit.

Listed funds should review their material contracts and any that are material to their underlying investee companies (if they have access to these) in order to determine whether the contracts need to be amended to ensure that they function as intended post-Brexit.

Risk factor disclosures

Listed funds will need to assess whether the risk factor disclosures on Brexit are still fit for purpose. Most Brexit risk factors have to date been limited to disclosing the existence of a referendum and stating that the outcome and impact of a vote to leave as being uncertain but potentially significant. As the shape of the post-Brexit world becomes clearer, the risk factors and the potential impact of Brexit should be updated.

Risk factors will need to be considered for any new offering documents, any AIFMD disclosure documents and annual reports. If an issuer is raising further equity capital, it is particularly important to have considered the impact of Brexit and have updated risk factor disclosures.

Investment policies

Investment policies typically prescribe portfolio diversification requirements based on (amongst other things) sector, geographic location and creditworthiness of the underlying investments. Changes in value or credit ratings of underlying investments may require the portfolio to be rebalanced, and managers will need to check whether their investment policies provide for an orderly rebalancing over a period of time or whether there is need for immediate action.

On a longer term basis, issuers should assess whether territorial restrictions in investment policies will still be fit for purpose post-Brexit (e.g. if an allocation to UK was previously included in an EU bucket) or needs to change.

Placing/share issuance programmes

Over the last few years, many listed funds have adopted 12 month placing and/or share issuance programmes. Those listed funds that have a “live” prospectus (i.e. one that an issuer could issue shares on the basis of and is under 12 months old) are under an obligation to publish a supplementary prospectus if there is a significant new factor, material mistake or inaccuracy relating to the information provided in the prospectus. This obligation applies regardless of whether the issuer intends to issue more shares under the relevant programme (unless the issuer decides to terminate the programme).

Whether the impact of Brexit on the listed fund is significant enough to trigger a supplementary prospectus is a question of fact. However if an issuer concludes that an announcement to the market needs to be made as a result of the Brexit vote impact, then this is likely also to require the publication of an supplementary prospectus.

Placing/share issuance agreements with sponsors, bookrunners, etc. are likely to have a number of material adverse change provisions that allows the sponsor or bookrunner to terminate the placing programme in the event of significant market disruption events. The Brexit fallout may or may not qualify, depending on the terms of the relevant agreement.

Similarly, there is likely to be a repetition of warranties on any closings. Issuers will need to consider whether potential Brexit fallout means that these warranties need to be qualified in anyway, and whether the placing/share issuance agreement contains a mechanism to qualify warranties.

Issuers will also need to consider whether presentations, factsheets and other materials that could constitute an investment advertisement need to be updated, in order to avoid breaching Rule 3.3.2 of the Prospectus Rules.

New share issues (including tap issues and scrip dividends)

In view of the market volatility that has resulted from the Brexit vote, listed issuers will need to be increasingly mindful of Listing Rule 15.4.11 that prohibits the issue of further shares of a class that is already listed for cash at a price below the net asset value unless they are issued on a pro rata basis to existing shareholders. This rule applies to all issues of shares unless the issue has been approved by shareholders.

Buy-backs

Whilst markets find their feet following the Brexit vote, there is a greater potential for listed fund shares to trade at a discount to their net asset value. Boards will be keen to monitor and manage these discounts and to use the tools at their disposal to effect this. Listed funds will need to be mindful of the changes to the market abuse regime in relation to PDMR dealings effective from 3 July 2016 and in particular the changes to the Listing Rules that may have an impact on certain market purchases.

Borrowing and leverage

Issuers should monitor changes in value of a listed fund’s investment portfolio to ensure that borrowing levels remain within the loan-to-value parameters contained within the borrowing policy. Listed funds will also need to consider loan-to-value and material adverse effect conditions and covenants in facility agreements, which may restrict the ability of the listed fund to draw down on the facility or worse, trigger an event of default.

Valuations

Whilst it is too early to predict the medium and longer term impact on the markets of the Brexit vote, volatility in the markets and a slow-down in transaction volumes are likely to make accurate valuations of assets more challenging. Listed funds should keep their valuation policies under review and should consider the need for pricing oversight committees, and possible increases in valuation frequency. They should also consider strategies for dealing with hard-to-value assets.

Currency risks and opportunities

The cocktail of domestic and EU politics that will determine the duration and destination of the Brexit journey, will inevitably impact the markets over the next couple of years. Issuers with assets and liabilities in a number of currencies will need to consider currency and exchange rate risks and whether to hedge these risks or capitalise on opportunities, if permitted by the issuer's investment policy. Whilst the vote to leave the EU itself does not create currency risk, the

price volatility of sterling on the currency markets shortly after the result was announced does highlight the potential for political events to have a dramatic effect on a variety of financial markets.

Preparation for opportunistic corporate actions

If markets soften and discounts start to emerge or widen, listed funds may become more at risk of opportunistic action from activist investors. If sterling also weakens, then the pricing of London listed, sterling denominated funds may become more attractive to overseas investors.

If market conditions are favourable to activist or special situation investors, it will be particularly important for issuers to monitor their shareholder register and to have in place some basic defence planning. A basic defence manual designed to assist the target and its advisers with the administrative and logistical steps involved in a defence can be invaluable to avoiding chaos and mistakes if a bid or shareholder requisition is made.



Medium to longer term impacts on listed funds

Brexit-driven restructurings?

The medium to long term impact of Brexit on listed funds will depend on the terms of the settlement between the UK and the EU which will govern the UK's post-Brexit relationship with the EU. Whilst there is no shortage of commentary on what this relationship might look like (and we set out some of the possible models on page 13), at this stage no one knows, as this depends on the outcome of negotiations which are yet to start. Indeed it is not clear when (and for some commentators, indeed if) the negotiations will start, as this will depend on if and when the UK triggers the process under Article 50.

Once the shape of the post-Brexit relationship becomes clearer, listed funds will need to consider whether they will need to restructure their operations for any of the following reasons:

- to ensure that they can raise capital from their target investor base;
- to ensure that they can continue to receive services from service providers such as AIFMs, investment advisers, depositaries and other financial services providers; and

- to ensure that their current domicile continues to provide the optimum tax and regulatory treatment when balanced with the operating costs of the jurisdiction.

What do listed funds need to do?

All listed funds should analyse the extent to which they are reliant on access to the Single Market in one form or another.

Those listed funds whose business model is reliant on being able to access the Single Market, either for capital (i.e. EU investors) or for services (i.e. EU AIFM, investment adviser or other financial services provider), will be more impacted than listed funds whose investors and operations are predominantly domestic UK.

Those listed funds that are not reliant on Single Market access can probably afford to wait until the nature of the UK's post-Brexit relationship with the EU becomes clearer. In contrast, those listed funds who are reliant on Single Market access, should explore the various restructuring options available to them now in order to ensure that their business is not adversely affected by Brexit.



What laws and regulations will apply to listed funds until Brexit?

EU laws and regulations currently in place or implemented before Brexit takes effect (unlikely to be much before 2019) will still be binding on and in the UK at least until then.

EU laws and regulations govern:

- how listed funds are managed (AIFMD and MiFID);
- how and to whom listed funds are marketed (AIFMD, the Prospectus Directive and from the end of December 2016 the PRIIPs KID regulation); and
- the continuing transparency and disclosure obligations to which listed funds and they are subject (Transparency, Disclosure and the new Market Abuse Regulation).

These laws and regulations (and the FCA rules that implement them, such as the Prospectus Rules, the Listing Rules, the DTRs and the new MAR) will continue to be in force at least until Brexit occurs.



Crystal ball gazing: the UK's future relationship with the EU

Drivers of the post-Brexit legal and regulatory environment

From a listed funds perspective, the extent of the impact of Brexit will be driven by the outcome of two main negotiating points.

- The first is the extent of the UK's access to the Single Market. This will determine (amongst other things) the extent that non-EU listed funds can raise capital from European investors, either through a marketing passport or under a national private placement regime. It will also determine the extent to which service providers such as AIFMs, investment advisers, depositaries and their delegates can continue to provide services to listed funds on a cross-border basis.
- The second is the extent to which the UK must retain rules and regulations that are equivalent to EU rules in order to gain full or limited access to the Single Market. A requirement for full or limited equivalence will restrict the ability of the UKLA and HM Treasury to remove defunct provisions or unnecessary 'red-tape' laws, rules and regulations that have originated in Europe, so many of the Prospectus Rules and DTRs, etc. are likely to continue to apply to listed funds, and some or all of the AIFM Directive is likely to continue to apply to managers.

Life post-Brexit under the current EU regime

Depending on exit terms post-Brexit, UK alternative investment fund managers (AIFMs) would be treated as non-EEA AIFMs and would only be able to market listed funds (which are categorised as alternative investment funds (AIFs)) to EEA investors under private placement arrangements if the Member States where the investors are based permit such marketing, or by way of reverse solicitation. This is the basis upon which Channel Islands domiciled investment companies are currently permitted to be marketed throughout the EEA (including the UK).

Under the AIFMD, a non-EEA (known as a "third country") passport may be introduced. This would allow non-EEA domiciled and managed funds to be marketed within the EEA if the manager is authorised and certain other conditions are met. However, at present, the introduction (and timing) of the third country passport is not certain.

Different Brexit models

There are a variety of potential post-Brexit relationship models. The table below shows some of the different models for the UK-EU post-Brexit relationship that may be negotiated. The UK Government has yet to indicate which relationship model it favours; and it is unlikely to do so until later this year. Whatever model is adopted will require the agreement of the UK and all remaining EU Member States (other than the "Full Divorce"), and it is possible that another relationship model may ultimately prevail.

Possible post-Brexit models

	Full Divorce (no special relationship between UK and EU)	Free Trade (wide ranging free trade deal)	Pick & Mix (free trade deal with greater alignment in particular areas)	Associate Membership (EEA not EU; special status with some Single Market access)	Adjusted Membership (UK still in EU on revised terms – possibly also changes in rEU)
Influence	– UK outside policy process	– UK outside policy process	– UK outside policy process – Consulted as “best friend”?	– UK outside policy process – Consulted as “best friend”?	– UK involved in policy development
Financial	– No UK contribution to EU budget	– No UK contribution to EU budget	– Possible reduced UK contribution to EU budget	– Significant UK contribution to EU budget	– Significant UK contribution to EU budget
People	– Qualitative controls – no favourable UK/rEU terms	– Qualitative controls possibly with favourable UK/rEU terms	– Free movement to work with some enhanced specific “brakes” or qualitative controls	– Free movement to work with some enhanced specific “brakes”	– Free movement possibly with some enhanced specific “brakes”
Law and regulation of listed funds and managers	– No particular alignment of UK and EU laws. – No requirement for UK legislation implementing AIFMD, MiFID, Prospectus Directive, MAR, PRIIPs, etc. to continue (although they will continue to apply unless specifically replaced).	– No express alignment between UK and EU laws – No requirement for UK legislation implementing AIFMD, MiFID, Prospectus Directive, MAR, PRIIPs, etc. to continue (although they will continue to apply unless specifically replaced)	– Alignment of laws in specified areas – If the UK successfully negotiates a financial services passport, then UK legislation implementing AIFMD, MiFID, Prospectus Directive, MAR, PRIIPs, etc. equivalent provisions will continue to apply, but subject to UK law. – The UK may consider adopting a dual regulatory regime, where funds can opt-out of EU equivalent legislation if they don't require access to the Single Market.	– UK follows EU laws in many current areas – If the UK successfully negotiates a financial services passport, then UK legislation implementing AIFMD, MiFID, Prospectus Directive, MAR, PRIIPs, etc. equivalent provisions will continue to apply. – The UK may consider adopting a dual regulatory regime, where funds can opt-out of EU equivalent legislation if they don't require access to the Single Market.	– UK follows EU laws in many current areas – UK legislation implementing AIFMD, MiFID, Prospectus Directive, MAR, PRIIPs, etc. equivalent provisions will continue to apply. – Dual track regime unlikely.
Marketing of UK funds in the EU	– EU marketing by NPPR (if permitted by the relevant Member State) or reverse solicitation. – Possible use of non-EU passport, subject to ESMA: (a) turning on the non-EU passport regime; and (b) deeming UK law as equivalent to EU law. Equivalence would only be granted if the UK retained the provisions implementing EU directives.	– EU marketing by NPPR (if permitted by the relevant Member State) or reverse solicitation. – Possible use of non-EU passport, subject to ESMA: (a) turning on the non-EU passport regime; and (b) deeming UK law as equivalent to EU law. Equivalence would only be granted if the UK retained the provisions implementing EU directives.	– EU marketing by NPPR (if permitted by the relevant Member State) or reverse solicitation. – Possible use of non-EU passport, subject to ESMA: (a) turning on the non-EU passport regime; and (b) deeming UK law as equivalent to EU law. Equivalence would only be granted if the UK retained the provisions implementing EU directives.	– Access to Single Market – Marketing Passport for UK domiciled funds – Possible use of non-EU passport for non-EU/non-UK funds, subject to ESMA turning on the non-EU passport regime.	– Access to Single Market – Marketing Passport for UK domiciled funds – Possible use of non-EU passport for non-EU funds, subject to ESMA turning on the non-EU passport regime.

How Hogan Lovells can help?

We have conducted an in-depth analysis of how Brexit could affect different industry sectors and worked with a range of clients to develop their contingency planning. We understand the range of issues and responses.

We can help you in assessing implications for material contracts and investment mandates, and in reviewing market communications to ensure that potential liability is minimised whilst providing a useful update to the markets. We can also work with you to prepare for market volatility and to help design strategies which both capitalise on opportunities, and also mitigate adverse impacts.

As the legal landscape emerges from the referendum fog, we can alert you to relevant developments and advise on whether your current domicile and structure continues to provide the optimum tax and regulatory treatment when balanced with the operating costs of different possible structuring solutions.

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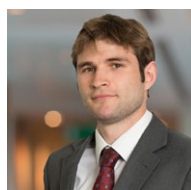
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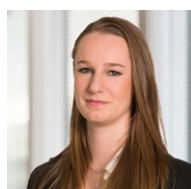
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