Hogan Lovells

ParalympicsGB OFFICIAL PARTNER

FUNDS BULLETIN **JANUARY 2016**

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1. GLOBAL AND EU DEVELOPMENTS

1.1 AIFMD: The Commission responds to ESMA's opinion and advice on the Non-EU Passport

The European Commission has responded to the European Securities and Markets Authority (ESMA)'s advice and opinion on the application of the Alternative Investment Fund Managers Directive (AIFMD) passport to non-EU alternative investment fund managers (AIFMs) and alternative investment funds (AIFs) (the Non EU passport). The Commission supports ESMA's country-by-country approach and intends to make a decision about the non EU passport and the national private placement regimes (NPPRs) once a sufficient number of countries have been appropriately assessed. It also agrees that ESMA should produce another opinion on the functioning of the EU passport and NPPRs once the AIFMD has been fully transposed in all of the EU and there is more experience on the functioning of this framework.

ESMA has been asked to complete the following by 30 June 2016:

- a re-assessment of the regimes of the USA, Hong Kong and Singapore. These countries formed part of ESMA's initial review, but, unlike the other phase one states: Jersey, Guernsey and Switzerland, did not receive a greenlight from ESMA;
- the assessment of six "phase two" jurisdictions: Japan, Canada, Isle of Man, Cayman Islands, Bermuda and Australia (see letter).

In particular, the Commission has invited ESMA to provide a more detailed assessment of the capacity of supervisory authorities and their track record in ensuring effective enforcement.

1.2 Hedge funds: results of HSFB cyber-attach simulation

The Hedge Funds Standards Board (HSFB) announced that it has held its first table top cyber-attack simulation for hedge fund managers in London; see also HSFB's memo on cyber security.

The objective of the simulation was to explore the response of hedge fund managers to three realistic cyber-attack scenarios:

- data theft and leakage of internal sensitive data;
- financial infrastructure attack;
- crypto ransomware.

Points arising from the simulation were:

- confusion over responsibilities can prevent an effective response. Managers should not consider cyber security as just an IT issue, given the legal, compliance, investor relations and reputational issues involved;
- certain types of cyber-attacks may exceed a manager's internal response capabilities. Managers should be prepared to quickly access external legal and IT expertise;
- preparation in advance, through a cyber security incident response plan, is important. This planning establishes responsibilities, pre-identifies external resources and speeds decisions should there be an actual incident.

1.3 Solvency II Delegated Regulation on treatment of infrastructure and ELTIF investments: scrutiny period extended

The European Parliament has published a letter, to the Commission, relating to the Delegated Regulation amending the Solvency II Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets (including infrastructure) held by insurance and reinsurance undertakings. In response to interventions from Invest Europe and other associations, the European Commission has proposed a new infrastructure definition. Infrastructure investments meeting this definition would enjoy a 30% risk weight.

The deadline for raising objections to the Amending Regulation has been extended by three months to 30 March 2016. A letter has also been sent to the Council of the European Union giving the same information.

1.4 EBA guidelines on limits on exposures to shadow banking entities

The European Banking Authority (EBA) has published its final guidelines entitled "Limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework" under Article 395(2) of the Capital Requirements Regulation'. These Guidelines follow the consultation paper issued last year and introduce an approach that will allow EU institutions to set internal limits for their exposures to shadow banking entities.

In the original proposal, undertakings for collective investment in transferable securities (UCITS) that are money market funds (MMFs) and, notably, all AIFs would fall within the definition of 'shadow banking entity'. In response to industry suggestions, the final guidelines state that AIFs with limited leverage could be considered to fall outside the definition of shadow banking entities. However, only AIFs which are not allowed to originate loans or purchase third parties' lending exposures and add them to their balance sheets would be excluded from the definition of 'shadow banking entity'. This relaxation is a welcome improvement of the original wording and will reduce the number of shadow banking AIFs which would have had to comply with additional, and potentially conflicting, regulation.

1.5 European Commission Securities Financing Transactions Regulation

The Securities Financing Transactions Regulation applies directly in the EU from 12 January 2016 and aims to improve the transparency of the securities financing markets and will apply to UCITS management companies and AIFMs. The Regulation aims to improve transparency in three main ways:

- By requiring that securities financing transactions (for example any transaction where securities are used to borrow cash) are reported to a central database. The responsibility for doing this will lie with the management company of UCITS and AIFMs.

- By requiring detailed reporting to investors of investment funds engaged in securities financing transactions and total return swaps. These should be detailed in both regular reports of the funds and in pre-investment documentation.

- By increasing the requirements for reuse (any pre-default use of collateral by the collateral taker for their own purposes), including written agreement and prior consent from investors; please see our client briefing.

1.6 MAR Level 2 Directive adopted by the Commission

The European Commission has adopted a Level 2 Delegated Regulation supplementing Regulation on market abuse (MAR). Details contained within the Level 2 Regulation include: (i) indicators of market manipulation; (ii) circumstances under which trading during a closed period may be permitted by an issuer; and (iii) types of transaction triggering the duty to notify managers' transactions. The requirements of MAR will come into effect on 3 July this year; see our client briefing.

1.7 Investment firms: EBA response to European Commission call for advice

In response to a European Commission call for advice, EBA (in collaboration with ESMA) has issued a report on the prudential regime for investment firms to tackle its complexity and potential lack of risk sensitivity.

The EBA recommends:

- a new categorisation of investment firms, distinguishing between systemic and "bank-like" investment firms to which full CRD IV requirements should be applied, and other investment firms, namely those that are considered "not systemic" or "not interconnected", for which specific requirements should be defined;

- the development of a prudential regime for "non-systemic" investment firms;

- the extension of the waiver for commodity trading firms, which are currently benefitting from the exemption under both the large exposures and capital adequacy provisions, until 31 December 2020. This extension would allow regulators to assess whether a more proportionate framework is suitable for these firms.

1.8 Liquidity management tools in CIS: IOSCO report

The International Organisation of Securities Commissions (IOSCO) has published a report on liquidity management tools in collective investment schemes (CIS). The report maps existing liquidity management frameworks in 26 member jurisdictions, with a particular focus on tools to help deal with exceptional situations (for example, significant redemption pressure).

The report includes the following observations:

- many liquidity management tools are available to jurisdictions, some of which are specifically tailored to the features and nature of the funds considered (for example, money market funds, real estate funds, and hedge funds). In particular, most jurisdictions clearly distinguish open-ended schemes from closed-ended ones;
- the most common tools are redemption fees, redemption gates, redemption in kind, side pockets, and suspension of redemption;
- funds are generally required to have appropriate risk management and internal quality controls to ensure that all material risks are properly identified, assessed, monitored and controlled;
- open-ended funds are generally subject to additional regulatory requirements dealing with fund leverage, asset concentration, investor concentration, restrictions on illiquid asset investment and short-term borrowings.

IOSCO, through its committee on investment management, is conducting work on enhancing collection of data about asset management activity and is considering developing guidance on liquidity risk management beyond its 2013 principles.

1.9 Joint Committee of ESAs identifies errors in November 2015 consultation paper on KIDs for PRIIPs

The Joint Committee of the European Supervisory Authorities (ESAs) issued an errata relating to its November 2015 consultation paper on key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs).

The errata corrects two formulas relating to the market risk measure (MRM), which are set out in paragraphs 27 and 28 of Annex II to the consultation paper (see pages 37 and 38).

The consultation paper relates to Article 8(5) of the Regulation on KIDs for PRIIPs (PRIIPs Regulation), which requires the committee to develop draft regulatory technical standards (RTS) on the content and presentation of the KIDs for PRIIPs. The consultation closes on 29 January 2016.

The RTS and accompanying impact assessment will be submitted to the European Commission for endorsement by 31 March 2016. The committee will also publish feedback to the consultation at that time.

2. UK Developments

2.1 AIM: revised AIM Rules for Companies

The London Stock Exchange has published AIM Notice 43 to confirm changes to the AIM Rules for Companies and the AIM Note for Investing Companies (effective from 1 January 2016). The Exchange has implemented the rule changes to AIM Rule 8 (investing companies), AIM Rule 15 (fundamental changes of business), the Guidance Notes on AIM Rule 15 and paragraph 5.2 of the AIM Note for Investing Companies.

The new version of the AIM Rules also includes the minor changes arising from the CSD Regulation.

2.2 FCA policy development update no 29

The FCA's Policy development update no 29 includes:

- UCITS V implementation and other changes to the Handbook affecting investment funds, which is due in February 2016; and
- Policy proposals and Handbook changes related to the implementation of the Market Abuse Regulation; due in Spring 2016.

2.3 Private equity: The Private Equity Reporting Group eighth report on conformity with Walker Guidelines

The Private Equity Reporting Group (formerly the Guidelines Monitoring Group) published its eighth annual report on disclosure and transparency in private equity, assessing conformity with the Walker Guidelines, see press release. Key findings include:

- 95% of those portfolio companies reviewed achieved a level of compliance that would benchmark well against the better performers in the FTSE 250 compared to 100% compliance in 2014.

- 19 of the 20 portfolio companies reviewed made the full audited report and accounts (or an alternative report) available on their websites, with the Group noting that some companies still believe that access to reports at Companies House would suffice. During 2016, the Group intends to monitor whether companies publish their accounts on a timely basis and within six months of year end, as required by the Guidelines. Also, only eight of the portfolio companies reviewed included a statement of compliance with the Guidelines, now required under the Guidelines as amended in July 2014. None of the sampled companies adopted an 'explain' approach within the 'comply or explain' model.

- Portfolio companies have improved the quality of disclosure on key performance indicators, trends and factors affecting the future of the company, environmental matters and social and community issues. However, on the new reporting requirements, few of the sampled portfolio companies included information on gender diversity, and quality of disclosure was mixed as regards an explanation of the business model and commentary on human rights issues. Performance against Guidelines-specific requirements to disclose the identity of its private equity firm and composition of its board has also fallen compared to 2014.

Going forward, the Group will continue to monitor changes in narrative reporting, including the Financial Reporting Council (FRC) statements implementing the Sharman Panel's recommendations, together with implementation of the requirements of the Modern Slavery Act 2015. As with previous years, the enterprise values set out in the Guidelines will be monitored in light of developing European legislation and regulation, and the Group will continue to review the quality of private equity firms' disclosures about their own activities. The report also notes the Group's intention to publish an updated Good Practice Guide in early 2016.

2.4 Investment Association guidance on paperless renunciation or transfers of units in authorised CISs

The Investment Association (IA) has published industry guidance on the paperless renunciation or transfers of units in authorised collective investment schemes (CISs).

The guidance provides a non-exhaustive statement of the measures that operators of UK authorised CISs may adopt to comply with the requirements of rule 4.4.13(3)(b) of the FCA's Collective Investment Schemes sourcebook (COLL), and paragraph 4C of Schedule 4 to the Open-Ended Investment Companies Regulations 2001 (OEIC Regulations) (as amended). These requirements provide that title to units in UK authorised unit trusts, authorised contractual schemes and open-ended investment companies (OEICs) may be transferred on the strength of an authority given by electronic means. These provisions are subject to the unit trust manager or authorised corporate director (ACD) taking reasonable steps to ensure that the communication is given by the unitholder (or an agent they have appointed in writing). The guidance is designed to help authorised fund managers determine the steps they should take to satisfy the reasonable steps requirement. The guidance relating to renunciation of title is applicable both when dealing as principle or as agent on behalf of a fund.

The guidance has been prepared for use in connection with renunciation and transfer of title under the laws of England and Wales, and Scotland. Differences that affect transfers in some circumstances under the laws of Northern Ireland have not been considered, in the absence of any funds known to operate under them.

The guidance has received confirmed industry guidance status from the FCA, which status took effect on 4 January 2016 and lasts for a period of five years.

3. UK Tax Developments

3.1 Property groups say BEPS will cost UK sector £660m

The FT reported that the British Property Federation has written to the Treasury minister to try and persuade the government to amend how it implements the OECD rules on base erosion and profit shifting. The current proposals have been estimated as resulting in an extra £660m of tax being due, based on data from De Montford University on UK property debt.

A consultation on implementation of the BEPS recommendations ended on 14 January 2016. Legislation is due to come into force next year.

4. US TAX DEVELOPMENTS

4.1 2015 PATH Act Exempts Certain Non-U.S. Pension Funds from FIRPTA and Limits the Impact of FIRPTA on REITs and their Non-U.S. Investors

In December, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), which facilitates foreign investment in U.S. real estate in a number of ways, including by (i) fully exempting certain non-U.S. pension funds from tax imposed under the Foreign Investment in Real Property Tax Act (FIRPTA), (ii) increasing from 5% to 10% the amount of stock a foreign portfolio investor can own in publicly traded REITs without incurring FIRPTA tax, and (iii) permitting certain widely-held, publicly traded foreign investors to qualify for such treatment as portfolio investors in REITs, regardless of whether the REIT is public or private. Attached is a more detailed client alert on some of the key provisions of the PATH Act related to U.S. real estate related investments by non-U.S. investors.

The introduction of a full exemption from FIRPTA tax for qualified foreign pension funds (QFPFs) that own U.S. real estate in any form is a very significant change in law. As background, FIRPTA generally requires non-U.S. investors to file a U.S. tax return and pay U.S. tax on gain from the disposition of a U.S. real property interest (USRPI). A USRPI is generally defined to include interests in U.S. real property (whether held directly or through one or more partnerships) and certain interests in corporations that own substantial U.S. real property (such corporations, USRPHCs). Additionally, a distribution by a real estate investment trusts (REIT) to a non-U.S. investor of net capital gain is subject to FIRPTA tax if the distribution is attributable to the REIT's disposition of USRPIs.

As a result of the PATH Act, on or after December 18, 2015, any disposition of a USRPI (including stock of REIT or USRPHC or U.S. real estate held directly or indirectly through one or more partnerships) by a QFPF, or any distribution to a QFPF by a REIT, is exempt from FIRPTA. Non-U.S. persons other than QFPFs will generally continue to be subject to U.S. tax on such sales and distributions in the same manner as they were prior to the PATH Act. Note that the PATH Act generally does not alter existing taxation of effectively connected income and commercial activity income outside of the FIRPTA context for QFPFs.

A QFPF is any foreign trust, corporation, or other organization or arrangement:

- which is created or organized under the laws of a country other than the United States;
- which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered;
- which does not have a single participant or beneficiary with a right to more than five percent of its assets or income;
- which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and
- with respect to which, under the laws of the country in which it is established or operates, either (i) the contributions to such organisation or arrangement are tax deductible or excluded from the gross income of such entity or taxed at reduced rates, or (ii) the taxation of any investment income of such organisation or arrangement is deferred or taxed at a reduced rate.

A QFPF includes a foreign entity wholly-owned by a QFPF.

As the PATH Act could have a very significant beneficial impact for non-U.S. pension funds that qualify as QFPFs, we recommend that non-U.S. pension funds consider whether they expect to qualify as a QPFP. We are happy to assist in this regard.

While Section 892 already offered non-U.S. governments a limited exemption from FIRPTA for gain on the disposition of an interest in a USRPHC (provided such corporation is not controlled by the non-U.S. government), other FIRPTA gain has not been eligible for the Section 892 exemption. It is not entirely clear yet how the definition of QFPF will apply to pension plans of non-U.S. governments as the PATH Act does not expressly address foreign government pension plans that qualify for Section 892. Many non-U.S. governments provide retirement benefits to citizens or residents, regardless of whether the citizens or residents have been employees. Non-U.S. pension funds created as part of a social security system may cover self-employed individuals or unemployed individuals who make voluntary contributions. As a result, the requirement that a QFPF provide benefits to employees may prevent certain non-U.S. government pension plans from being QFPFs. Additionally, it is not clear whether the annual reporting requirement would be met (i) if such reporting is voluntary (rather than a requirement of local law), (ii) where no such reporting exists because it would be between various units of the same non-U.S. government, or (iii) where such reports are made to a governmental unit other than a tax authority. Although many questions remain, it would be good to begin considering whether such government related investors may be eligible to qualify as QFPFs.

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