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TABLE OF CONTENTS

CLAUSE — PAGE

1. GLOBAL AND EU DEVELOPMENTS 2
1.1 Custody of CIS assets: IOSCO report on standards 2
1.2 Responses to ESMA's UCITS remuneration guidelines 2
1.3 MiFID II – Delayed implementation until January 2018 2
1.4 Shadow Banking: ECB Report on financial structures and FSB report 2
1.5 HFSB issues revised Hedge Fund Standards 3
1.6 PRIIPs Regulation: Joint Committee of the ESAs consults on key information documents 3
1.7 Commission Work Programme – 2016 and Call for evidence on the EU regulatory framework for financial services 3
2. UK DEVELOPMENTS 4
2.1 The European Long-term Investment Funds Regulations 2015 4
2.2 UCITS V: HM Treasury consultation and responses to FCA's consultation 4
2.3 Listed Funds: FCA Handbook changes to Listing Rules 4
2.4 Listed Funds: consultation on changes to AIM Rules for Companies 5
2.5 ISAs: Flexi ISA and Innovative finance ISA (loan-based crowdfunding sector) 5
2.6 Investment Association principles of remuneration 2015 5
2.7 FCA bans Magnus Peterson from the financial services industry 5
3. US DEVELOPMENTS 6
3.1 Department of Labour Clears Way for Pension Fund Impact Investing 6
4. EU TAX DEVELOPMENTS 6
4.1 EU Commission rule Luxembourg and Dutch tax authority rules were illegal state aid 6
5. UK TAX DEVELOPMENTS 6
5.1 Revenue and Customs Brief 17 (2015) – deduction of VAT on pension fund management costs 6
6. US TAX DEVELOPMENTS 7
6.1 New Partnership Audit Rules 7

1. Global and EU Developments

1.1 Custody of CIS assets: IOSCO report on standards

The International Organisation of Securities Commissions (IOSCO) has published its final report on standards for the custody of collective investment scheme (CIS) assets.

The report aims to clarify, modernise and further develop international guidance for the custody of CIS assets, consistent with IOSCO's core objectives and principles of securities regulation.

The report sets out standards aimed at identifying the core issues that should be kept under review by the regulatory framework to ensure investors' assets are effectively protected. It reaffirms the importance for the regulatory framework to provide for suitable custodial arrangements to be in place, clear segregation requirements and appropriate independence. The standards also relate to the appointment and on-going monitoring of custodians.

The report also identifies some of the key risks associated with the custody of CIS assets, such as operational risk, misuse of CIS assets, risk of fraud or theft, and information technology risk.

1.2 Responses to ESMA's UCITS remuneration guidelines

AIMA has responded to the European Securities and Markets Authority (ESMA) consultation paper on guidelines on sound remuneration policies under UCITS V and the Alternative Investment Fund Managers Directive (AIFMD). AIMA supports ESMA’s approach to the application of the proportionality principle and encourages ESMA to retain the possibility for firms to dis-apply certain remuneration principles, where it is proportionate for them to do so.

INREV has also responded to ESMA's consultation recommending adoption of the AIFMD Guidelines, including the proportionality principle.

1.3 MiFID II – Delayed implementation until January 2018

The European Commission has stated that implementation of MiFID II is likely to be delayed until January 2018. ESMA’s Steven Maijoor has said that the timing for the implementation of MiFID II would be "extremely tight" and delays to the finalisation of regulatory technical standards mean that some of the IT systems that are required for the implementation of MiFID II will not be ready by January 2017. He acknowledged that ESMA itself faces significant challenges in building a "substantial" IT system to compile a list of all financial instruments traded in the EU.

According to Maijoor, ESMA has raised with the Commission the possibility of delaying certain parts of MiFID II, mainly related to transparency, transaction reporting and position reporting. A spokesman for the Commission has separately confirmed that its preliminary view is that a delay in the implementation of MiFID II may be necessary.

Michael Thomas, partner in our financial institutions group, said:

"*Up until now the European institutions have been consistent in stating that the January 2017 deadline for MiFID II implementation would be met. However, the industry has been increasingly vociferous in calling for a delay, especially over the last couple of months. ESMA has now bitten the bullet, by recognising that it's not just investment firms, but also the regulatory authorities, who will struggle to get their systems ready in time for January."*

See further our MiFID II microsite: http://www.hoganlovells.com/mifidii/.

1.4 Shadow Banking: ECB Report on financial structures and FSB report

In a recent consultation paper on limiting banks' exposure to shadow banking, the European Banking Association (EBA) defined "shadow bank" as including alternative investment funds (AIFs) and money market funds (MMFs). No UCITS, other than MMFs, would be covered by this definition. Various organisations, such as the Association of Real Estate Funds (AREF) and InvestEurope (formerly EVCA) have objected to the fact that AIFs form part of this definition (see July Funds Bulletin). Classifying AIFs as shadow banks would mean that they will also be subject to potentially conflicting banking regulation; there is evidence of policy differences between ESMA (the securities regulator) and EBA/ the European Central Bank (ECB) and the Financial Stability Board (FSB).

More recent shadow banking developments are ECB's Report on financial structures, including investment funds. Points to note:

- The shadow banking sector growth over the past year has been driven primarily by non-MMF investment funds (i.e. AIFs), which expanded owing to net inflows and rising valuations. The weakening of the euro vis-à-vis other currencies contributed to this, as the share of assets invested outside the euro area amounts to 40%.
- Euro area MMFs expanded as well, following a protracted period of decline, with net flows into these funds having stabilised since mid-2014.

1.5 HFSB issues revised Hedge Fund Standards

The Hedge Fund Standards Board (HFSB) has issued a revised version of its Hedge Fund Standards, following a public consultation launched in March 2015 on managing conflicts of interest.

The HFSB has also made available a tracked changes version of the Standards, for comparison purposes.

The amendments that have been made to the Standards are designed to strengthen internal compliance procedures and improve disclosure of conflicts of interest, specifically in the areas of parallel funds, including employee funds and the aggregate size of employee and partner co-investment in those funds.

The revised Standards will come into force on 2 May 2016 to allow HFSB signatories sufficient time to achieve conformity with them.

1.6 PRIIPs Regulation: Joint Committee of the ESAs consults on key information documents

The Joint Committee of the European Supervisory Authorities (ESAs) (ie EBA, ESMA and the European Insurance and Occupational Pensions Authority) have published a consultation paper on draft regulatory technical standards (RTS) which the Joint Committee is mandated to develop under Article 8 (5) of the Regulation on key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs) (PRIIPs Regulation).

The European Commission has also published a report (plus executive summary) on the consumer testing study that it has carried out relating to the possible new format and content for the PRIIPs KID.

Comments are requested by 29 January 2016. The Joint Committee will hold a public hearing on the consultation in Frankfurt on 9 December 2015. The RTS and accompanying impact assessment will be submitted for endorsement by the European Commission by 31 March 2016. Feedback on the consultation will also be published at this time.

1.7 Commission Work Programme – 2016 and Call for evidence on the EU regulatory framework for financial services

The Commission has launched its 2016 Work Programme which sets out the measures it intends to pursue in the coming year. There is a great deal of focus on geopolitical issues such as migration, the EU's role on the global stage, and terrorism. The financial services priorities listed are predominantly presented in the context of driving growth and achieving the Capital Markets Union (CMU).

Key areas of interest are:

- The review of the Prospectus Directive
- Reviews of the functioning of the European Venture Capital Fund (EuVECA) and European Social Entrepreneurship Fund (EuSEF) Regulations
- Completion of Banking Union with legislative proposals with legislative proposals outlining steps towards a European Bank Deposit Insurance Scheme based on a reinsurance mechanism
- A legislative initiative framing a new approach to business failure and insolvency
- A new corporate tax legislative package including measures to enhance transparency and fight tax avoidance, including implementing international standards on BEPS, and a staged approach starting with a mandatory tax base together with the withdrawal of the existing CCCTB proposal

As part of its CMU project, the European Commission has launched a Call for Evidence on the EU regulatory framework for financial services. This provides an opportunity to highlight current rules that are disproportionate relative to the benefits that they deliver. The Commission will consider changing rules where industry highlights specific concerns.

2. UK DEVELOPMENTS

2.1 The European Long-term Investment Funds Regulations 2015

The European Long-term Investment Funds Regulations 2015, SI 2015/1882, which come into force on 3 December 2015, make changes to primary and secondary legislation required in order to give effect to the Regulation on European Long-term Investment Funds (the ELTIF Regulation). The EU Regulation on ELTIFs will be directly effective in Member States from 9 December; see our ELTIF client briefing.

Among other things, the Regulations:

- amend the Financial Services and Markets Act 2000 to enable the Financial Conduct Authority (FCA) to act against managers who contravene the ELTIF Regulation, and to clarify that it is a criminal offence to mislead the FCA in relation to purported compliance with a requirement imposed by the ELTIF Regulation;
- insert a new Part 3A into the Alternative Investment Fund Manager Regulations 2013, SI 2013/1773, giving the FCA power to direct the procedure for authorising a fund as an ELTIF and when revoking authorisation;
- amend the Financial Services and Markets Act 2000 (Qualifying EU Provisions) Order 2013, SI 2013/419, to specify the ELTIF Regulation as a qualifying EU provision, thus enabling the FCA to enforce directly applicable requirements arising from the ELTIF Regulation and any directly applicable EU regulations made under it.

A related explanatory memorandum and transposition table have also been published.

2.2 UCITS V: HM Treasury consultation and responses to FCA's consultation

The amendments to the Undertakings for Collective Investments in Transferable Securities Directive (known as UCITS V) deal with depositary functions, remuneration policies and sanctions for failure to comply with the Directive.

UCITS V will primarily be implemented through changes to the Financial Conduct Authority (FCA) rules (see our September Funds Bulletin). HM Treasury's consultation paper covers changes or additions to the Financial Services and Markets Act 2000 and relevant secondary legislation which primarily relate to the depositary and sanctions. Remuneration provisions will be implemented via Handbook changes.

A draft version of The Undertakings for Collective Investment in Transferable Securities Regulations has also been published together with an impact assessment. Comments are requested by 17 December 2015.

2.3 Listed Funds: FCA Handbook changes to Listing Rules

The FCA Handbook has been amended to be aligned with the 2014 version of the Corporate Governance Code; see Handbook notice 26. These changes related to:

- the requirement for premium listed issuers to report on the extent to which they comply or do not comply with the provisions of the revised Code;
- the requirement for directors to make disclosures relating both to the going concern basis; of accounting and to the long-term viability of the entity in line with the relevant provisions; of the revised Code; and
- various changes to the LR relating to the numbering and revised content of the Code.

Changes include an amendment to Listing Rules Chapter 16.2 (eligibility for listing for an open ended investment company). This has been amended to reflect the removal of the requirement for electronic settlement (which affects various rules in LR 6 and 9).

Part of the instrument came into force on 23 October and the remainder on 1 December 2015.

2.4 Listed Funds: consultation on changes to AIM Rules for Companies

The London Stock Exchange's AIM Notice 42 sets out proposed changes to the AIM Rules for Companies which apply to investing companies and to AIM companies that undertake a fundamental change of business (together with consequential changes required to the AIM Note for Investing Companies).

The LSE proposes to amend AIM Rule 8 (investing companies) to increase the amount in cash that an applicant seeking admission as an investing company must raise via an equity fundraising on, or immediately before, admission from £3 million to £6 million.

There were also proposed amendments to AIM Rule 15 (fundamental changes of business) to delete the provision that deems an AIM company which becomes a cash shell following a fundamental disposal to be an investing company.

2.5 ISAs: Flexi ISA and Innovative finance ISA (loan-based crowdfunding sector)

The FCA's discussion paper, DP15/6, sets out possible changes to the FCA Handbook relating to the loan-based crowdfunding sector, including:

- the proposal to allow loan-based crowdfunding investments (Article 36H agreements in the Regulated Activities Order (RAO), usually known as peer-to-peer (P2P) agreements) to be included in individual savings accounts (ISAs), in a new component to be known as an Innovative Finance ISA (IFISA). The new IFISA is expected to be available from 6 April 2016;
- the proposal to amend the RAO to make the provision of advice about loan-based crowdfunding investments that are RAO article 36H agreements (P2P agreements) a regulated activity.

Comments are requested by 31 December 2015. The FCA is planning to publish a policy statement making final rules in March 2016.

A related development is Flexible ISAs. From 8 April 2016 ISA Managers will be able to offer "Flexible ISAs" which will allow cash (including cash from Stocks and Shares ISAs) withdrawn to be replaced within the same tax year without being treated as a new subscription. HMRC has issued ISA Bulletin 68, including draft regulations and guidance and requesting feedback.

2.6 Investment Association principles of remuneration 2015

The Investment Association has published the 2015 revised version of its principles of remuneration. The principles of remuneration set out members' views on the role of shareholders and directors in relation to remuneration and the manner in which remuneration should be determined and structured.

An introductory letter outlines the key changes made to them for 2015, highlights the issues of concern for Investment Association members at the current time and provides more details on the Investment Association's executive remuneration working group which is seeking to establish a simpler structure of executive remuneration.

The only change made to the previous edition of the principles of remuneration relates to length of performance and holding periods for long term incentives. The principles have been updated to make it clear that it is now members' expectation that long term incentives have a performance and holding period of at least five years.

2.7 FCA bans Magnus Peterson from the financial services industry

The FCA has announced that it had banned Magnus Michael Peterson, the former head of the hedge fund Weavering Macro Fixed Income Fund Limited, from performing any function related to any regulated activity. Mr Peterson was convicted of a range of fraud offences through the hedge fund resulting in losses to clients of approximately $536m and sentenced to a total of 13 years' imprisonment at Southwark Crown Court.

Full details are given in the Final Notice.

3. US DEVELOPMENTS

3.1 Department of Labour Clears Way for Pension Fund Impact Investing

On October 26, 2015, the US Department of Labor issued guidance making it easier for pension plan fiduciaries subject to ERISA to take environmental, social and corporate governance issues into account when selecting investments, in addition to just investment returns. It did so by withdrawing guidance it issued in 2008 and replacing it with the guidance that existed before 2008. Both sets of guidance allow pension plan fiduciaries to choose one investment over another based on environmental, social and governance considerations only if the two investments are otherwise equal with respect to return and risk over the appropriate time horizon. However, the 2008 guidance seemed too many to create a presumption against taking those considerations into account, and perhaps require additional documentation or evaluation for so-called “economically targeted investments” beyond that required for plan investments generally. As a result, according to the Department of Labor, the 2008 guidance has “unduly discouraged” fiduciaries from considering economically targeted investments. Although the new guidance does not focus on corporate governance issues, they might, in fact, be the main reason for issuing the new guidance, as pension plans are major institutional investors, and several recent US corporate governance reforms such as say-on-pay rely on shareholder involvement to succeed.

4. EU TAX DEVELOPMENTS

4.1 EU Commission rule Luxembourg and Dutch tax authority rules were illegal state aid

On 21 October 2015, the EU Commission published a press release which announced that "selective tax advantages" granted by the Dutch and Luxembourg tax authorities constitute illegal state aid:

"Tax rulings cannot use methodologies, no matter how complex, to establish transfer prices with no economic justification and which unduly shift profits to reduce the taxes paid by the company."

Of particular interest to investment funds may be the nature of the tax rulings concerned in the decision. The Luxembourg and Dutch tax rulings were specific to the facts, and approved the use of complex structures which resulted in low taxes. This type of ruling should be distinguished from more general guidance received from tax authorities about how domestic tax laws are to be interpreted.

The decision does not prevent tax authorities from providing information and guidance about the application of general tax laws; it is specifically focused rulings which rest upon, and authorise, "*economically unjustifiable assumptions*".

5. UK TAX DEVELOPMENTS

5.1 Revenue and Customs Brief 17 (2015) – deduction of VAT on pension fund management costs

HMRC published a new brief relating to the deductibility of VAT on pension fund costs on 26 October 2015. The brief follows on from the decision of the CJEU in *Fiscale Eenheid PPG Holdings BV cs te Hoogezand* (C-26/12).

Prior to the CJEU decision, whether an employer could recover VAT on employee pension costs depended on whether they were related to investment supplies (not recoverable) or administration supplies (recoverable). In the case of a split supply, the employer could treat 30% as administration and 70% as investment.

The decision in *PPG Holdings* established that an employer could recover VAT on all of the costs related to the pension benefits, because the scheme was set up to benefit employees. However, HMRC clarified that this recovery depended on the employer contracting for the services directly. Given that most employee pension schemes involved a trustee contracted for services rather than the employer, employers were likely to lose the ability to recover administration supplies and fail to meet the CJEU test for recovery.

To resolve the issue, employers entered into tripartite contracts for providing pension services, along with the trustee and service provider. In March of this year, HMRC stated that this practice was permissible. The tripartite scheme appeared to meet the requirements of pension law, and still allow recovery of VAT.

However, HMRC has recognized a side-effect of the tripartite contracts that investment costs could not be deducted for corporation tax purposes. This significantly reduced the benefit to employers.

The newly published brief considers two potential solutions:

- A paymaster arrangement, which would resolve the corporative tax deduction issue but not the VAT issue; and
- Grouping the employer and trustee for VAT purposes, although this would not allow recovery of investment management costs.

Due to the uncertainty about the correct approach to take, HMRC will retain the transition period for the old 70/30 split supply regime until the end of 2016.

6. US Tax Developments

6.1 New Partnership Audit Rules

The Bipartisan Budget Act of 2015 (the "Budget Act") signed into law by President Obama on November 2 repeals current partnership audit rules and reporting and audit procedures for “electing large partnerships” and adopts new partnership audit rules (the “new rules”) effective for partnership taxable years beginning after December 31, 2017. Under the current partnership audit rules, although partnership audit issues and underpayment liabilities are assessed at the partnership level, the IRS is generally required to allocate the partnership tax liability to, and collect if from, the partners (which has proved challenging for the IRS, particularly in the case of tiered partnership structures and partnerships with a large number of partners). In contrast, under the new rules, if the IRS assesses a deficiency against a partnership, the partnership will generally be liable for the tax due which is to be imposed at the highest individual or corporate tax rate (currently 39.6%). However, the Budget Act instructs the IRS to establish procedures under which the tax due can be modified to better reflect the amount properly owed to the government based on the character of underpaid income and the nature of the partners.

The new rules will apply to all partnerships (including limited liabilities that are classified as partnerships for U.S. federal income tax purposes) with more than 100 partners and to partnerships with 100 or fewer partners if any of the partners is a partnership or a trust. Other partnerships may affirmatively elect out of the new rules (an “opt out” election). For an opt out election to be made with respect to a given tax year, the partnership is required to file the election with the partnership’s timely filed tax return for that tax year and to also disclose the name and taxpayer identification number of each partner (unless U.S. Treasury provides alternative identification for foreign partners). The partnership must also notify each partner of the opt out election. Note that the opt out election is unlikely to be available for investment funds with tiered partnership structures.

The new rules generally require a partnership to pay the tax assessed by the due date of the partnership’s tax return (without regard to extensions of time to file) for the year in which the adjustment is determined (with no deduction for any payment required to be made by the partnership). Thus, a partner in the year of the assessment may be liable for a tax deficiency that relates back to a tax year in which it was not yet a partner. However, under the new rules, as an alternative, the partnership may affirmatively elect to place the economic burden of the assessed tax on the persons or entities that were partners in the tax year to which the deficiency relates. In that case, the partnership furnishes to the IRS and to each such partner an adjusted Schedule K-1 reflecting such partner’s share of the adjustment. Each recipient partner is then required to increase its tax liability accordingly. This election must be made no later than 45 days after the date of the notice of final partnership adjustment.

The new rules require each partnership that does not elect out of the new rules to designate a “partnership representative” that will assume sole authority to act for the partnership in an audit proceeding. The partnership representative need not be a partner but must have a substantial presence in the U.S. The actions of a partnership representative will be binding on both the partnership and the partners. This could deprive some partners of rights in audits. If the partnership fails to designate a partnership representative the IRS may select a person to fill the role.

Partnerships should consider whether they are eligible to, and want to, elect out of the new rules and partnerships that will be governed by the new rules should ensure their operating agreements properly address and comply with the new rules.

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