FUNDS BULLETIN

OCTOBER 2015

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1. GLOBAL AND EU DEVELOPMENTS

1.1 AIFMD passport: Steven Maijoor submission to ECON

The European Securities and Markets Authority (ESMA) has announced that its Chair, Steven Maijoor, had appeared before a scrutiny session of the European Parliament's Economic and Monetary Affairs Committee (ECON) regarding the application of the Alternative Investment Fund Managers Directive (AIFMD) non-EU passport.

In his statement Mr Maijoor outlined ESMA's current work on its opinions in relation to third-country regimes, including:

- ESMA will continue its assessment of Hong Kong, Singapore and the US with a view to reaching a definitive conclusion on whether to extend the passport to those countries;
- it will start to assess a second group of non-EU countries, namely Australia, Canada, Japan, the Cayman Islands, the Isle of Man and Bermuda;
- it will focus on putting in place the extensive framework foreseen by the co-legislators in case the passport is indeed extended to one or more non-EU countries. This last element includes making preparations for ESMA's role in the functioning of the passporting system and the strengthened supervisory cooperation that will be crucial to its success.

The European Commission is expected to make an announcement this month in relation to the non-EU passport.

1.2 AIFMD: ESMA updates Q&As

ESMA has published an updated version of its questions and answers document (Q&As) on the application of the AIFMD. The Q&As now clarify (in section VI (depositaries)) that when an alternative investment fund's (AIF) depositary sub-delegates custody of the AIF's assets to either an EU or third-country central securities depositary (CSD), that CSD must comply with the provisions on delegation under Article 21(11) of the AIFMD.

1.3 Review of the EuVECA Regulation and EuSEF Regulation: European Commission consultation paper

The European Commission has published a consultation paper on a review of the European Venture Capital Funds Regulation (the EuVECA Regulation) and the European Social Entrepreneurship Funds Regulation (the EuSEF Regulation).

The objective of the consultation paper is to collect further information on the performance of the current legislation and identify measures the Commission could propose to increase take-up of the two new fundraising passports for venture capital and social entrepreneurship funds.

The consultation paper looks in particular at more technical issues such as the restrictions on who is able to manage the funds, lowering the level of minimum investment of EUR100,000 for investors (which would broaden the number of private investors able to invest in EuVECAs and EuSEF). It also looks at:

- whether non-EU managers should be able to offer EuVECA or EuSEF funds;
- broadening the range of eligible assets available to EuVECAs;
- reducing the expense of establishing a EuVECA or a EuSEF; and
- the consequences of the portfolio of assets of a EuVECA or a EuSEF manager exceeding the EUR500 million threshold.

The consultation was published in parallel with the Commission's capital markets union (CMU) action plan (see 1.6 below), which states that the Commission will take steps (presumably through legislative proposals) to revise the EuVECA Regulation and the EuSEF Regulation in the third quarter of 2016.

Comments are requested by 6 January 2016.

1.4 UCITS V Directive: ESMA final draft ITS on penalties and measures

ESMA has published its final report containing final draft implementing technical standards (ITS) on penalties and measures under the UCITS V Directive. The final draft ITS have been delivered to the European Commission for endorsement.

ESMA says that it did not conduct an open public consultation on the draft ITS as this would have been disproportionate in relation to their scope and impact, taking into account that they are addressed to NCAs and not market participants.

National competent authorities (NCAs) are required to provide ESMA annually with aggregated information regarding all penalties and measures imposed in accordance with Article 99 of the UCITS Directive (as amended by UCITS V). Administrative penalties or measures that are disclosed to the public by NCAs must be simultaneously reported to ESMA.

The ITS are expected to apply from the UCITS V transposition deadline, 18 March 2016.

1.5 ESMA 2016 work programme

ESMA has published its 2016 work programme which sets out its priorities and planned activities. Key priorities for 2016 include:

- supervisory convergence, the establishment of a single rulebook and a shift from rulemaking to implementation;
- work on the MiFID II Directive and the Markets in Financial Instruments Regulation (MiFIR) (including guidelines and Q&As);
- data collection and management under MiFID II/MiFIR.

At the time of publishing this work programme, the capital markets union (CMU) action plan was being finalised and therefore ESMA's work programme does not include potential new tasks for ESMA which may arise from the CMU.

1.6 Solvency II: European Commission adopts Delegated Regulation amending Delegated Regulation on treatment of infrastructure and ELTIF investments

The European Commission has adopted a Delegated Regulation amending the Solvency II Delegated Regulation concerning the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings, together with annexes to the Amending Regulation and a set of frequently asked questions.

By making a number of amendments to the Solvency II Delegated Regulation, the Commission is primarily changing the way the rules apply to insurers' investments in infrastructure and European Long-Term Investment Funds (ELTIFs):

- the amending Regulation introduces a new concept of "qualifying infrastructure investments": these are investments that present better risk characteristics than other infrastructure investments. Insurers will need to hold a lower level of capital against their investment in these infrastructure projects. "Qualifying infrastructure investments" will form a distinct asset category under Solvency II and will benefit from an appropriate risk calibration, lower than that which would otherwise apply;
- it allows investments in ELTIFs to benefit from lower capital charges under Solvency II. This brings them in line with investments in European Venture Capital Funds and European Social Entrepreneurship Funds, which benefit from the same equity capital charge as equities traded on regulated markets-lower than that for other equities.

The European Parliament and the Council of the European Union have up to three months to exercise their right of objection to the Amending Regulation, with the possibility to extend this period for another period of three months at their initiative. Either institution also has the right to reject the amendment. Following the expiry of this objection period, the Amending Regulation will be published in the Official Journal of the European Union and will enter into force on the day following the date of its publication.

1.7 EVCA changes its name to Invest Europe

The European Private Equity and Venture Capital Association (EVCA) has announced that it has changed its name to Invest Europe: The Voice of Private Capital; see its new website.

Invest Europe describes itself as the voice of investors in privately-held companies in Europe. From the outset, it has represented European venture capital and it has grown to encompass private equity and infrastructure, together with long-term investors (such as pension funds and insurance companies) that provide capital for investment.

The change of name was overwhelmingly endorsed by Invest Europe's members, in recognition of the industry's evolution since the association was founded over 30 years ago. Invest Europe says that it is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

1.8 Cyber-security for hedge fund managers: HFSB memo

The Hedge Fund Standards Board (HFSB) has announced the publication of a memo on cyber-security for hedge fund managers.

The memo provides:

- a brief overview of existing high-level cyber risk management tools, which fund managers can use to develop their tailored approach to cyber security;
- a framework to identify a firm's key digital assets;
- a list of practical "quick win cyber security action items"; and
- an overview of cyber security projects to enhance a firm's resilience, including the development of an incident response plan.

The last section focuses on what regulators want to see in terms of cyber risk preparedness, including an overview of regulatory requirements, guidance and approaches to cyber security for a number of key jurisdictions.

2. UK DEVELOPMENTS

2.1 Limited Partnership Reform Consultation

We participated in a joint city law firm response to the Limited Partnership Reform Consultation which was submitted earlier this month. Currently, there is no indication as to when HM Treasury (HMT) will publish any further measures, but this is not likely to be until the end of this year.

Summary of the proposals

In July, HMRC published a consultation which set out proposed changes to the Limited Partnership Act 1907. These were intended to remove many uncertainties and inconveniences in existing UK limited partnership law in order to ensure that English and Scottish limited partnerships remain the preferred structures for European private equity and venture capital funds (and other types of private funds); see further our article.

The proposed changes are only intended to apply to limited partnerships which are "private fund vehicles", and include:

- a white list of permitted activities for limited partners which will not amount to taking part in the management of the limited partnership business;
- the removal of:
  - the requirement for limited partners to make a capital contribution; and
  - the liability of limited partners for capital contributions that have been withdrawn.
- the partners should be able to agree among themselves who should wind up the limited partnership (without having to obtain a court order);
- removal of some of the details that must be specified when a limited partnership is registered (including the amount of capital contributed), and when such details change;
- removal of the requirement for advertisements in the Gazette of transfers;
- removal of duties to render accounts and information, and to account for profits made in competing businesses;
- an ability for the registrar to remove from the register entries for inactive limited partnerships.

Amendments suggested by law firms

We agreed with a majority of HMT's proposals. Our main suggested amendments are set out below.

(a) The private fund limited partnership (PFLP) definition should be clarified and amended to capture more types of fund vehicles. Therefore, a PFLP should be (or be expected to be) a collective investment scheme (CIS) within the meaning of FSMA s. 235(1) - (4), disregarding s. 235(5) and the CIS Exemptions Order.

(b) It should be possible to register existing limited partnerships as PFLPs any time after the LRO comes into force (rather than within 12 months of the LRO coming into force).

(c) A solicitor's certificate certifying that the PFLP is a CIS should not be necessary; instead the general partner or the operator should be able to confirm the business intention of the limited partnership.

(d) Designation as a PFLP on the certificate of registration should be conclusive evidence that the limited partnership is a PFLP.

(e) A removal of a PFLP from the register should not have the effect that the PFLP becomes a general partnership where the partners have unlimited liability. There are various solutions to this, including that the limited partnership must have been dissolved in order to be de-registered, or that it should be moved to a separate register of inactive PFLPs where liability is unchanged.

(f) The "white list" of permitted limited partner activities is welcome, but it should be clear that the list is non-exhaustive. Also, it should be clear that the white list is not prescriptive, but a matter for commercial agreement between the parties.

(g) Suggested additions to the "white list" include rights for limited partners:

- to take part in decisions relating to amendment of the investment period; and
- in a feeder fund to direct how the feeder fund exercises its rights in the underlying limited partnership (look through voting).

(h) In relation to capital contributions, the response states that we recognise that some private fund sponsors may wish to continue with the traditional capital/loan split (which the LRO permits) even if this is no longer required. Note (albeit this is not mentioned in the response) that some firms may decide that carried interest partners continue with a capital/loan split to ensure their carried interest benefits from capital treatment (instead of income treatment).

2.2 **AIMA response to FCA consultation on ELTIFs**

AIMA has responded to part II of the UK Financial Conduct Authority's (FCA) consultation paper (CP15/27), which proposes changes to the FCA Handbook in order to ensure the EU Regulation introducing European long-term investment funds (ELTIFs) will operate effectively. AIMA commented that requiring managers of ELTIFs that can only be marketed to professional investors to change their permissions and subjecting them to the resultant additional handbook requirements may be an unnecessary compliance burden which could deter alternative investment fund managers from structuring their funds as ELTIFs. AIMA therefore suggested that a distinction be made in the Handbook between ELTIFs that can be sold to retail clients and those which can only be sold to professional investors; see our ELTIF client briefing.

3. **US DEVELOPMENTS**

3.1 **Proposal to Extend Enhanced AML Requirements to Registered Investment Advisers.**

Currently, U.S. banks and registered broker dealers are subject to enhanced anti money laundering (AML) standards under the Bank Secrecy Act (BSA), but investment advisers and privately offered investment funds are not. Rules were originally proposed more than a decade ago, but never adopted, that would extend enhanced standards to many private investment funds offered to institutional and high net worth investors.

In August, 2015, the Financial Crimes Incentive Network (FinCen) within the U.S. Department of Treasury published a notice of proposed rulemaking that would apply enhanced standards to investment advisers registered or required to be registered under the Investment Advisers Act of 1940, but not to investment advisers that are exempt from SEC registration, such as foreign private advisers and exempt reporting foreign private fund advisers. The rule, if adopted, would include such investment advisers within the definition of "financial institutions" subject to higher AML standards. FinCen is seeking guidance on the following elements of an enhanced AML standard for registered investment advisers: (a) establishment and implementation of policies, procedures, and internal controls; (b) providing for independent testing for compliance to be conducted by company personnel or qualified outside parties; (c) designation of persons responsible for implementing and monitoring the operations and internal controls of the program; and (d) provision of on-going training. Investment advisers subject to this new rule would also be required to file suspicious activity reports (SARs). See full release.

It does not appear that these rules would extend to investment advisers not required to register with the SEC. FinCen is also seeking comment on whether the compliance requirements for foreign registered advisers should be modified.

3.2 High Profile Enforcement Actions against Private Equity Fund Managers for Alleged Disclosure Violations and Breaches of Fiduciary Duty.

The SEC has been active in bringing enforcement actions against some of the largest private equity managers in the U.S. for what it alleges are breaches of fiduciary duties and inadequate disclosures to private fund investors. Very substantial penalties (tens of millions of dollars) were assessed in each of these cases. Although key facts underlying these matters came to light during routine presence examinations to which only registered advisers are subject, many of the claims in these cases are based on breaches of fiduciary duties to which exempt advisers are also subject. Therefore, our clients may wish to consider reviewing their compliance programs and fund disclosures in light of some of the underlying fact patterns that were criticized by the SEC.

In October, 2015, the SEC settled an enforcement action with certain Blackstone entities that it claimed failed to disclose to fund investors (i) acceleration of monitoring fees upon the sale or IPO of portfolio companies, only a portion of which was subject to management fee offset, and (ii) that Blackstone had negotiated discounts with its preferred law firm for Blackstone corporate work that were more favourable than legal fee arrangements for Blackstone fund work.

In August, 2015, the SEC settled an enforcement action with Guggenheim Partners for inadequate disclosure of a material loan arrangement between a senior executive of the firm and a client that enabled the executive to participate in a buyout transaction being led by the firm. The SEC alleged that this arrangement caused the firm to put a principal's personal interests ahead of client interests, thus violating the investment adviser fiduciary duty.

In June, 2015, the SEC settled an enforcement action with KKR arising out of KKR's policies for allocation of broken deal and certain other expenses, which the SEC alleges were not fairly allocated to certain co-investment vehicles maintained for firm executives and certain other key client co-investment vehicles.

All registered advisers should be attentive to the fact that the SEC appears to be singling out the private equity fund industry for increased scrutiny of their activities and fact patterns that may form the basis for allegations of disclosure and fiduciary duty violations. In the case of fund advisers not subject to registration, fiduciary duties are implicated by having the status of an investment adviser under U.S. laws (i.e., having U.S. clients or advising private funds in which U.S. clients invest), and not triggering the threshold for registration (i.e., having non-fund clients above the $25 million foreign private adviser exemption threshold, or, in the case of advisers whose only clients are U.S. funds, having a place of business in the U.S. from which portfolio management activities are conducted). While advisers not required to be registered are not currently subject to inspection, the risk remains that the SEC could nonetheless bring a similar case if relevant facts came to its attention.

3.3 SEC Chair Speech on the Status of the Private Fund Industry Five Years after Dodd-Frank

The SEC's chairperson last week made a major address to a leading fund industry group highlighting the cases discussed above and other SEC initiatives applicable to the private fund industry. We suggest you read it closely. Among other matters highlighted were increased scrutiny of real estate fund advisers' arrangements with related party service providers and the need for registered advisers to maintain adequate cyber security compliance programs, in particular to protect the privacy of client financial data.

4. Global Tax Developments

4.1 BEPS final package released

The OECD has presented the final package of measures for reform of international tax rules: Base Erosion and Profit Shifting (BEPS), which identifies 15 actions to put an end to international tax avoidance. The plan aims to introduce coherence in the domestic rules that affect cross-border activities; align taxation with the location of economic activity and value creation; and improve transparency. The focus now shifts to implementation of the BEPS measures.

The BEPS measures include new minimum standards on: country-by-country reporting; treaty shopping; curbing harmful tax practices (in particular regarding IP); and mutual agreement procedures to avoid double-taxation. Transfer pricing rules are also revised along with the definition of Permanent Establishment.

The BEPS package offers governments a series of new measures to be implemented through domestic law changes, including strengthened rules on Controlled Foreign Corporations, a common approach to limiting base erosion through interest deductibility and new rules to prevent hybrid mismatch arrangements from making profits disappear for tax purposes through the use of complex financial instruments.

Nearly 90 countries are working together on the development of a multilateral instrument capable of incorporating the tax treaty-related BEPS measures into the existing network of bilateral treaties. The instrument will be open for signature by all interested countries in 2016. Furthermore, the G20 finance ministers have endorsed the BEPS final package at their meeting in Lima, Peru.

5. UK Tax Developments

5.1 HMRC practice announcement following the Supreme Court decision regarding double taxation relief: George Anson v HMRC

The Supreme Court considered the question of whether Mr Anson was entitled to double taxation relief for US tax against his UK tax on income received from a Delaware LLC of which he was a member.

Mr Anson contended that the profits of the Delaware LLC belonged to the members as they arose and hence Mr Anson was taxed on the same profits in the UK as had been taxed in the US. HMRC contended that Mr Anson received a distribution from an LLC, and no double taxation relief was due because the LLC entity had been taxed on its profits. The Supreme Court agreed with Mr Anson and restored the decision of the First-Tier Tribunal.

HMRC has now released a practice announcement, however, outlining that where US LLCs have been treated as companies within a group structure, they will continue to be treated as such by HMRC. HMRC's existing approach to whether a US LLC issues share capital will also continue. Individuals seeking to rely on the *Anson* decision will be considered on a case by case basis.

6. US Tax Developments

6.1 Final Sec. 706 Regulations on Tax Year of Partnerships

U.S. Treasury Regulations finalized on August 3, 2015 modify rules controlling how a partnership determines its tax year. The final regulations generally apply to partnership tax years that begin on or after August 2, 2015 (and, as a result, calendar-year partnerships generally would apply the final regulations to their 2016 tax years and beyond). Under current U.S. tax law, a partnership is required to adopt the majority partner's tax year and, if there is no majority partner, the tax year of its principal partners, and, if neither exists, a tax year that limits the amount of deferred income to partners. A foreign partner's interest is generally disregarded for these purposes unless the foreign partner is allocated income that is effectively connected with a US trade or business (ECI); however, if the regarded partners would hold only a "minority interest" in the partnership, then the foreign partner's interest is taken into account even in the absence of ECI. Under prior law, "minority interest" was defined as each regarded partner holding an interest of less than 10% of "capital or profits," and all regarded partners holding in aggregate less than 20%. The Final Regulations replace the language with "capital and profits." The effect of this change will be to follow the general rule of disregarding a foreign partner's interests in determining the tax year of a partnership unless each regarded partner holds less than a 10% interest in capital and less than a 10% interest in profits and all regarded partners hold in aggregate less than a 20% interest in each. The change is significant because when a general partner holds a small percentage of capital but is allocated 20% or more of profits, interests held by foreign partners will more likely be disregarded in determining the partnership tax year thereby increasing the likelihood that the partnership's tax year will align with that of the regarded US partners. Certain partnerships, like those with large carried interests starting after a preferred return is paid, may be required to change tax years once the partnership begins to allocate profits to the carried interest. Partnerships formed prior to August 3, 2015 are exempt from the application of this new rule.

6.2 IRS Released New Notice Extending FATCA Transitional Rules and Final Version of IRS Form 8966 Released

In September, the IRS released Notice 2015-66 announcing that FATCA will be amended to extend certain transitional rules. Under previous FATCA rules, gross proceeds from the sale or disposition of property that is U.S. sourced was to be subject to withholding after January 1, 2017. The notice extends the start date of FATCA withholding by two years, so that withholding will not be required until January 1, 2019. Similarly, under previous FATCA rules, foreign pass-thru payments made by foreign financial institutions (FFI) in compliance with FATCA to non-compliant FFIs and account holders was to be subject to withholding after the later of January 1, 2017 or the date of publication of final regulations defining "foreign pass-thru payment". The notice postpones the start date of withholding to the later of January 1, 2019 or the date of publication of such final regulations. In October, the IRS also released the final version of the FATCA report, IRS Form 8966.

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21 October 2015

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