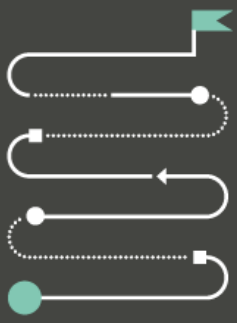
BRIEFING

TRAVERS SMITH

Funds Annual Briefing 2020

Our annual briefing highlighting the key 2019 legal developments which impact the funds' industry and previews what can be expected in 2020.



January 2020

4135-6788-1761

TIMELINE OF UPCOMING DEVELOPMENTS

HEADLINE GRABBERS

- 'Getting Brexit Done' – what happens now?
- The structures and products behind the GP-led secondaries and liquidity solutions trend
- Firms should now be compliant with the UK Senior Managers and Certification Regime
- An increased focus on sustainable finance, which is set to continue
- Illiquid assets and open-ended funds under scrutiny yet again following Woodford fund collapse
- New Swiss distribution regime which may affect your future marketing and distributions to Swiss investors

RECAP: WHAT YOU MAY HAVE MISSED

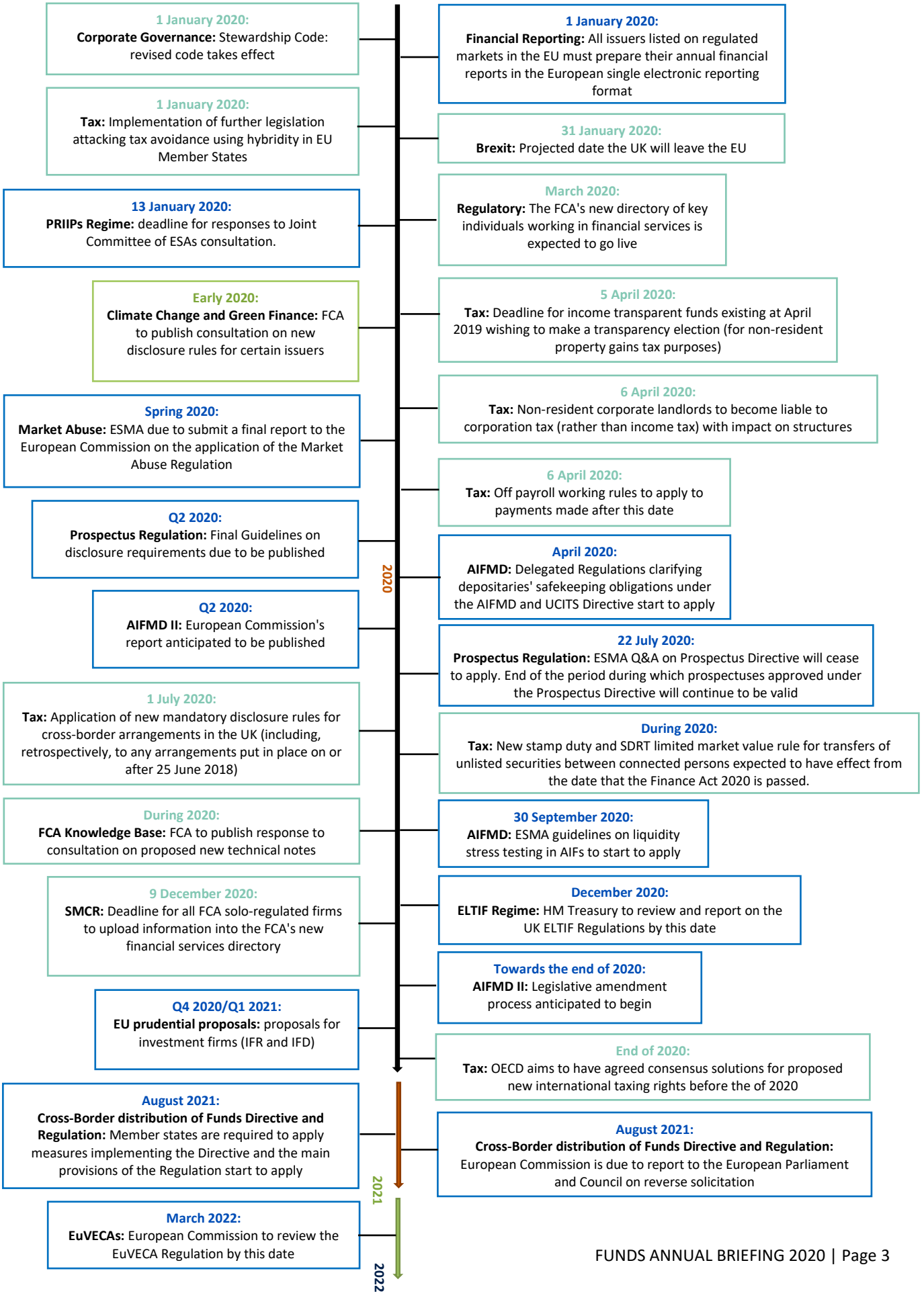
- ILPA issuing its first ever model form limited partnership agreement
- ILPA updating its guidance on best practices and principles
- Industry guidance, relating to GP-led secondary fund restructurings, was published to encourage productive dialogue between general and limited partners
- The publication of guidance to assist investment managers and general partners to interpret and apply the existing corporate transparency and beneficial ownership rules (CLLS Q&A on the PSC regime)
- The publication of the annual report (by the Private Equity Reporting Group) on disclosure and transparency and good practice reporting by the private equity industry
- The publication (by the Cost Transparency Initiative) of templates and tools for institutional investors to receive standardised costs and charges information
- A refined approach to the preparation, and publishing of, prospectuses introduced across the EU
- New rules on directors' remuneration and related party transactions to create parallel disclosure obligations to the Listing Rules regime, plus new obligations for SFS listed funds
- Potential for UK withholding tax in respect of fee rebate arrangements, following a recent Tribunal decision
- The implications of revisions to EU-wide derivatives legislation (EMIR 2.1) for AIFs
- EuVECA regime: clarification of conflict of interest rules governing EuVECA managers
- Electronic signatures: lengthy Law Commission review concludes they are valid, even for deeds

SPOTLIGHT: ON YOUR RADAR

- A focus by the European regulator on the application of the market abuse regime to collective investment undertakings
- Draft new guidelines on open-ended performance fees may be extended to also apply to AIFs
- Some new disclosure rules relating to climate change to be brought in by the FCA
- Upcoming amendments to the FCA's technical guidance applicable to listed funds
- A revised corporate governance AIC Code to apply to listed funds from 2020
- A revised Stewardship Code to apply to listed entities from 2020
- Calls for greater transparency in paying dividends

- Revisions to the Financial Reporting Council's ethical and auditing standards may mean auditors of certain private equity funds can only provide a limited range of non-audit services to that fund
- OECD aiming to introduce new international taxing rights that potentially impact the asset management industry at asset manager, fund and portfolio company levels
- New tax reporting regime for mandatory disclosure of cross-border arrangements (DAC 6) to come into force
- New payroll tax obligations to come into force for businesses which engage consultants through personal vehicles
- Further legislation attacking tax avoidance using hybridity to apply from 1 January 2020 in EU member states
- Practical issues arising for real estate fund managers in relation to the non-resident property gain rules
- Non-resident corporate landlords to become liable to corporation tax (rather than income tax)
- Limited market value rule to be introduced for stamp duty and SDRT for transfers of unlisted securities between connected persons
- A new regime relating to cross-border distribution of funds is on its way, including a new EU-wide pre-marketing definition
- New incoming liquidity stress testing guidelines will apply to AIFs and UCITS
- Higher regulatory capital requirements, more onerous remuneration rules, and a raft of other governance, disclosure and reporting requirements, will apply to most MiFID investment firms (by way of the Investment Firms Regulation and Directive)
- Important changes to money laundering obligations in force from 10 January 2020
- EU wide securities financing transactions' reporting obligations will soon include AIFs and UCITs
- The transition to a replacement rate following the discontinuation of LIBOR
- PRIIPs regime: proposed amendments to obligations relating to performance scenarios, past performance information, costs calculation methodologies and multi-option products
- ELTIF regime: proposed amendments to the disclosure of costs could require inclusion of carried interest in the presentation of costs

TIMELINE OF UPCOMING DEVELOPMENTS



1 HEADLINE GRABBERS

'GETTING BREXIT DONE' – WHAT HAPPENS NOW?

So we now have the outcome of the general election and, as many predicted, Boris Johnson has secured a large majority government. The agreement, made in October 2019, between the European Council and the UK to extend the Article 50 period by up to three months means that the UK will leave the EU at the end of the month in which ratification of the revised withdrawal agreement is concluded, up to 11.00 pm on 31 January 2020 (UK time). On 31 January, therefore, the UK will leave the EU whether or not the withdrawal agreement has been concluded, unless a further extension is agreed, or the UK revokes its Article 50 notice.

Does this mean that fund managers, alternative investment funds and their advisers finally have a clear picture of how Brexit will impact on the various legislation, rules and guidance which affect the investment funds' industry? Not quite, but the election result has brought an end, at least, to the uncertainty caused by the possibility of a second referendum or revocation of Article 50. We have set out below some of the key considerations relating to investment funds in the short and long term. But if we have learnt anything about politics over the past 3 years, it is that is extremely difficult to predict what happens next and it is possible that the analysis in this briefing may be overtaken by events.

Transition Period in the event of a Deal

The new Conservative majority government will now be able to secure the passage of its Bill implementing the renegotiated draft Withdrawal Agreement. The UK then has a transition period until 31 December 2020 in which to agree a deal with the EU on the future relationship. It is of course possible that the government will seek an extension of the transition period, notwithstanding current claims. See more on our views at Brexit Hub.

During the transition period, the revised withdrawal agreement provides that the UK will continue to be treated as an EU Member State. EEA full-scope alternative investment fund managers ("**AIFMs**") currently managing and/or marketing an EEA alternative investment fund ("**AIF**") under an AIFM passport will be able to continue to do so. Similarly, those AIFMs relying upon marketing using the national private placement regimes ("**NPPR**") will be unaffected.

No-Deal Brexit

Funds, and their advisers, should not abandon their efforts to prepare for a no deal Brexit outcome. There are several reasons for this:

- A no deal outcome at the end of January 2020 cannot be ruled out. The government has already hardened its stance on requesting an extension to the transition (indicating that it will not do so) and is may come under further pressure to commit to a so-called "clean Brexit" (which is effectively a no deal exit);
- Apart from the transition, the draft Withdrawal Agreement is primarily "backward-looking"; until agreement is reached on the future relationship, a no deal outcome on 1 January 2021 remains a possibility; and
- Even if a deal is reached with the EU on the future relationship, this is only likely to be possible by January 2021 if it is very much at the "harder" end of the Brexit spectrum. For certain sectors of the economy (such as financial services), this could be almost as disruptive as "no deal" and therefore "no deal" planning will still be of assistance in that scenario.

BREXIT

Funds, and their advisers, should not abandon their efforts to prepare for a no deal Brexit outcome.

As the UK will immediately become a third country in the event of a no deal, UK full-scope AIFMs will no longer be able to use the AIFMD marketing passport and will instead only be able to market under NPPR. Sub-threshold AIFMs will not be affected to the same extent as full-scope AIFMs; having never had access to the AIFMD passport, they will continue to market under

the NPPR. Similarly, non-EEA AIFMs would also continue to market under NPPR.

However, AIFMs marketing under the NPPR require, as a condition to access to the regimes, relevant co-operation agreements to be put in place between UK and Member State supervisors in relation to the exchange of information. In February 2019, the FCA and ESMA announced the agreement of a multi-lateral regulatory co-operation agreement("**Mmou**") between the FCA and EEA regulators. The text of the Mmou has not been published. The areas we would expect the Mmou to cover include (i) UK AIFMs marketing to EEA investors under NPPR; (ii) EU AIFMs delegating portfolio management to UK firms; and (iii) the cross-border management of funds. The FCA has confirmed that the Mmou is based on the existing memoranda of understanding which are currently in place in respect of the AIFMD, and that it meets the requirements set out in regulation 59 of the UK AIFM Regulations.

The AIFMD asset stripping provisions currently applicable to private equity funds' operations will no longer apply in respect of UK investments.

Private funds will have a number of additional considerations in relation to their portfolio companies, including (i) immigration, employment and travel; (ii) cross-border trade; (iii) reviewing licences and permits to ensure that there will be no disruption to the use of such; and (iv) intellectual property.

Individual Member States' preparations remain in a state of flux and vary considerably from jurisdiction to jurisdiction.

Additional and up to date disclosures will be necessary in annual reports in relation to Brexit, given that under the AIFMD an AIFM must include on the annual report any material change to the information disclosed to investors. Similarly, any live placing programme prospectuses should be reviewed to ensure any Brexit-related disclosures are adequate.

Material contracts should also be reviewed to determine whether any definitions of 'EU' or 'EEA' need to be updated so as to carve out the UK from such definitions.

AIFMs should consider whether any personal data is being transferred from the EEA to a third country (i.e. the UK post Brexit). Under the EU General Data Protection Regulation ("**GDPR**"), unless one of a number of specified arrangements is in place to provide adequate safeguards for personal data, the transfer of personal data from inside the EEA to third countries outside the EEA is restricted. This includes storage on a server in the EU. If so, the AIFM will need to ascertain whether the necessary safeguards are in place in relation to the transfer of that personal data.

Funds which have shares admitted to a regulated market in the UK and a dual-listing in another EEA state will need to make additional notifications to regulators for certain matters, including in relation to the post-Brexit UK market abuse regime. These obligations are in addition to existing obligations under EU market abuse regime.

For listed funds, to be eligible for admission to trading on the Official List/ Specialist Fund Segment, applicants must comply with *the* 'free float' requirement. The current free float requirement (that issuers must ensure that 25% or more of their issued shares are held in public hands in EEA states) will be amended so as to require 25% or more shares to be held by investors in any jurisdiction.

Also of relevance to listed funds, the UK's Disclosure, Guidance and Transparency Rules ("**UK DTRs**") will apply to all issuers with transferable securities admitted to trading on a UK regulated market, irrespective of their place of incorporation. The 'home/host' concept, which currently determines which Member State's rules apply, will not be relevant in the UK after Brexit. The UK HM Treasury has made an equivalence decision that determines EU-adopted IFRS to be equivalent to UK-adopted IAS for the purposes of the EU Prospectus Directive and Transparency Directive (HM Treasury are working on updating this to reflect the move to the Prospectus Regulation). On this basis, non-UK incorporated funds will be able to use EU-adopted IFRS when preparing consolidated accounts for financial years beginning on or after Brexit and will not have to translate the accounts into UK-IAS, so long as the FCA has granted such funds an exemption in relation to EU-adopted IFRS.

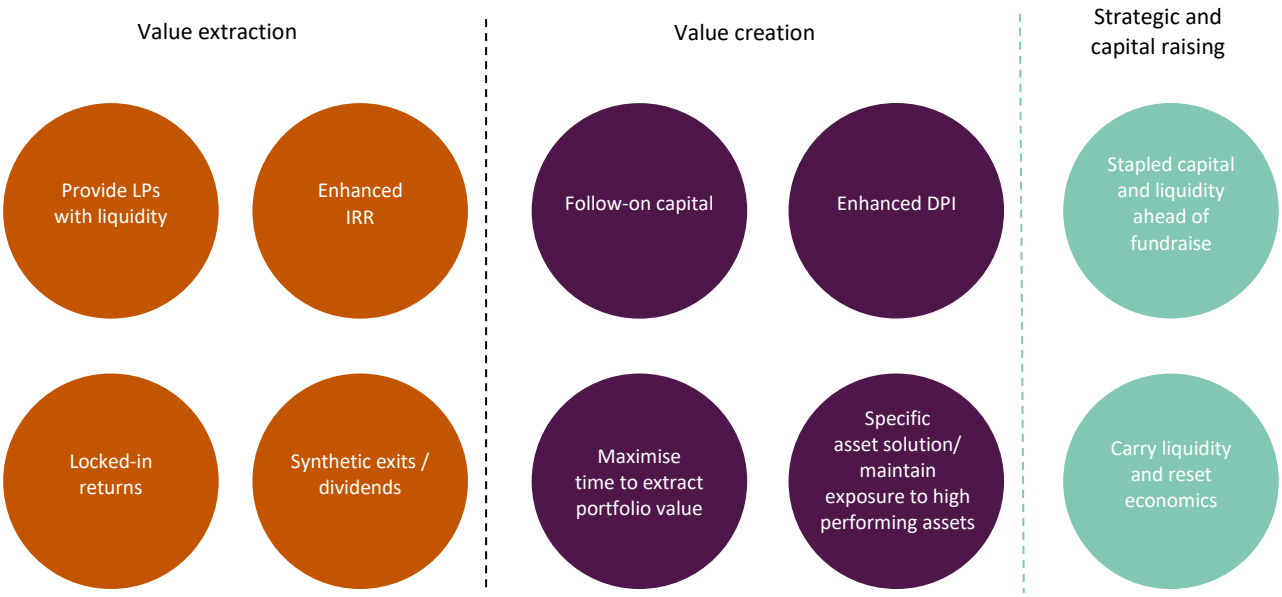
THE STRUCTURES AND PRODUCTS BEHIND THE GP-LED SECONDARIES AND LIQUIDITY SOLUTIONS TREND

Recent years have seen record fundraising in the secondaries market, with the 10 top secondaries funds alone seeking to raise more than $70billion in 2020. This has created a large pool of capital that GPs are increasingly looking to access in order to respond to their LPs' demand for liquidity, differentiated performance and sophisticated portfolio management. This pool of capital is also being accessed by GPs to maintain exposure to high performing assets, enhance the performance metrics of their funds, ensure that their LP base receives liquidity concurrent with a new fundraise, generate a 'stapled' commitment from a secondary buyer and to accelerate carried interest. GPs are using a wide range of structures to differentiate themselves within the market, such as portfolio sales, strip sales, preferred equity and NAV based lending.

In a typical GP-led secondary:

- The GP of a selling fund runs an auction process and, ultimately, arranges for a secondary fund to capitalise a continuation vehicle that is managed by the same GP that manages the selling fund.
- The continuation vehicle makes an offer to acquire some or all of the selling fund's portfolio with the price set by reference to NAV in the most recently available quarterly reports.
- The GP offers each LP the right to take liquidity at the offer price or to maintain its existing exposure to the portfolio.
- The GP is required to 'roll' some or all of the carried interest that it receives in respect of the transaction into the continuation vehicle as an investor commitment.
- The GP will receive a management fee and carried interest from the continuation vehicle.

Why are GPs looking at liquidity/financing options?



FIRMS SHOULD NOW BE COMPLIANT WITH THE UK SENIOR MANAGERS AND CERTIFICATION REGIME

The Senior Managers and Certification Regime ("**SMCR**") was extended to all firms authorised under the Financial Services and Markets Act 2000, including fund managers, on **9 December 2019**. Firms should now be compliant with the vast majority of the regime's requirements. Firms must have identified all of their Senior Managers and Certification Staff and ensured that they are trained on the new regime. The Conduct Rules applied to them as from 9 December 2019. However, there is a one-year transitional period as regards certain aspects so that firms have until **9 December 2020 at the latest**:

- To complete the initial certification process – i.e. to complete their fitness and propriety assessments and issue the first annual certificate in respect of Certification Staff;
- To train their other staff (i.e. all those employees, other than ancillary staff, who are not Senior Managers or Certification Staff but who are within the scope of the Conduct Rules); and
- To upload via Connect all the data about individuals that they are required to provide for the purposes of the FCA's new Directory.

AN INCREASED FOCUS ON SUSTAINABLE FINANCE, WHICH IS SET TO CONTINUE

Fund managers will need to adapt to an increased focus on sustainable finance over the next few years, as regulatory measures are introduced at both at an EU and UK level. This is set against a wider backdrop of global initiatives in the area of climate change.

In the context of financial services "Sustainable finance" generally refers to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions. The three components break down as follows:

- Environmental considerations – these refer to climate change mitigation and adaptations – and to the environment more broadly and the associated risks (such as natural disasters);
- Social considerations – these refer to (among others) issues of inequality, inclusiveness, labour relations, investment in human capital and communities;
- Governance considerations – these refer to management structures, employee relations and executive remuneration and their role in ensuring that environmental and social considerations are included in the investment decision-making process.

At an EU level, as part of the European Commission's Sustainable Finance Action Plan, the EU institutions have been working on a range of measures including a new taxonomy or classification system of environmentally sustainable activities, new disclosure requirements relating to sustainable investments and provisions designed to integrate sustainability risks and factors into the way that financial services firms do business and deal with clients. These EU initiatives will not be effective until after the UK has left the EU and the expiry of the EU Withdrawal Agreement transitional period. However, depending on UK policy with regards to implementing EU-derived legislation following Brexit, it is likely that they will have a direct impact on UK firms; and, in any event, the UK is also pursuing its own domestic agenda on these issues.

EU Regulation on sustainability-related disclosures in the financial services sector

The EU Regulation on sustainability-related disclosures in the financial services sector ("**EU Disclosure Regulation**") was published in the Official Journal on 9 December 2019 and came into force on 29 December 2019. The majority of its provisions will apply from **10 March 2021**. The EU Disclosure Regulation applies to portfolio managers, AIFMs, UCITS management companies, EuVECA managers and EuSEF managers as well as investment advisers.

The EU Disclosure Regulation is intended to complement the other work being carried out on sustainability including ESMA's work on the integration of sustainability risks and factors into firms' policies and procedures (see below).

The European Supervisory Authorities are required to develop regulatory and implementing technical standards in respect of many of the provisions of the EU Disclosure Regulation which will, among other things, further specify the details of the presentation and content of the information on sustainablity investment targets to be disclosed in pre-contractual documents, periodic reports and on websites. Some of these technical standards will come into force 12 months after the EU Disclosure Regulation comes into force; others will come into force 24 months *after the EU Disclosure Regulation comes into force.*

Broadly, under the EU Disclosure Regulation fund managers will be required to make a number of disclosures as follows:

- Disclosures on the firm's ***website***, to include:
  - The firm's written policies about the integration of sustainability risks in its decision making process;
  - A statement on its due dilgence policies with respect to the principal adverse impacts of investment decisions on sustainability (or, where the firm has not considered the adverse impacts of investment decisions on sustainabilty, clear reasons for not having done so);
  - For each financial product (e.g. AIF or UCITS) a description of its ESG characteristics – i.e. a description of the environmental or social characteristics or the sustainable investment objective; and
  - Certain information required in respect of pre-contractual disclosures and in periodic reports.
- ***Pre***-contractual disclosures of:
  - how sustainability risks are integrated into its investment decisions;
  - the likely impact of sustainability risks on investment returns; and
  - how the firm's remuneration policies take the integration of sustainabilty risks and sutainable investments into account.
- Disclosures in ***periodic reports*** that are broadly designed to prevent firms from "greenwashing" (i.e. the holding out of a product as having green or sustainable chacteristics where this is not, in fact, the case):
  - where a product seeks to promote environmental or social characteristics, a description of the extent to which these characteristics are obtained; and
  - where a product has certain sustainability objectives, a description of the overall sustainbility-related impact of the product (for AIFMs this must be included in the AIFM annual report as required by Article 22 AIFMD).

ESMA advice on integration of sustainability risks and factors

In response to a request from the European Commission for technical advice on potential amendments to, or the introduction of, certain delegated legislation, ESMA consulted on potential amendments to Level 2 measures adopted under AIFMD and the UCITS Directive and also under MiFID II. In May 2019, ESMA issued its two final reports containing its technical advice in respect of potential legislation on the integration of sustainability risks and factors into firms' policies and procedures.

The proposals will apply to AIFMs and UCITS management companies and to MiFID investment firms (including portfolio managers and adviser/arrangers). In some cases, the proposed requirements in respect of the MiFID II Level 2 measures would also apply indirectly to the manufacturers of funds (including non-EEA funds), particularly where making use of an EU distributor which is subject to MIFID.

Under the proposals, such firms would be required to take sustainability into account when complying with organisational requirements, including (where relevant) risk management, conflicts of interest and product governance requirements.

AIFMs and UCITS management companies would also need to integrate sustainability into the responsibilities of senior management and consider sustainability risks and factors when selecting and monitoring investments and when carrying out investment decisions.

Amendments to the relevant Level 2 measures under AIFMD, the UCITS Directive and MiFID II are likely to follow.

EU Taxonomy Regulation

The European Parliament and the Council have reached agreement on the Regulation for the establishment of a framework to facilitate sustainable investment ("**Taxonomy Regulation**"). This will introduce an EU-wide taxonomy or classification system of environmentally sustainable activities. It will establish the *framework* criteria for determining whether and to what extent an economic activity can be considered environmentally sustainable, with detailed criteria to follow (see below). In other words, by itself, the Regulation will not have any provisions which directly impose obligations on fund managers, but the taxonomy will have an impact on what can be considered environmentally sustainable and will therefore have a relevance in relation to those disclosures and other obligations which will apply to them directly (see above).

The Taxonomy Regulation will apply to:

- financial market participants who offer financial products; and
- financial and non-financial undertakings which fall under the Non-Financial Reporting Directive (i.e.

which are required to disclose how/to what extent their activities are associated with environmentally sustainable economic activities).

The six environmental objectives underpinning the criteria are as follows:

- climate change mitigation;
- climate change adaptation;
- sustainable use and protection of water and marine resources;
- transition to a circular economy;
- pollution prevention and control; and
- protection and restoration of biodiversity and ecosystems.

Parts of the Taxonomy Regulation are currently expected to take effect as from **31 December 2021** with the remainder coming into effect as from **31 December 2022**.

Further details as to what specific types of economic activities or investments are objectively defined as being environmentally sustainable (the technical screening criteria) will appear in yet-to-be drafted delegated legislation (RTS/ITS). Therefore the full impact of the Taxonomy Regulation will only apply once the relevant delegated acts under the Regulation, which will set out the relevant technical screening criteria for each of the relevant environmental objectives, have been established.

ILLIQUID ASSETS AND OPEN-ENDED FUNDS UNDER SCRUTINY YET AGAIN FOLLOWING WOODFORD FUND COLLAPSE

Open-ended funds and their holding of illiquid assets continued to dominate headlines in 2019. In September 2019, the FCA published its Policy Statement (PS 19/24) on illiquid assets and open-ended funds. This follows the publication of the FCA's Discussion Paper in 2017 (following the suspension of a number of property funds after the EU referendum) and the suspension in dealing in June 2019 of the LF Woodford Equity Income Fund. Both issues have led to renewed focus on illiquid assets held in open-ended funds. In particular, how fund managers use different liquidity risk management tools and how to strike a fair balance between the interests of investors wishing to redeem their holdings and those wishing to remain invested in the fund under difficult market conditions.

The new rules will introduce:

- A new category of 'funds investing in inherently illiquid assets' ("**FIIA**"). NURSs that fall into this category will be subject to additional requirements, including enhanced depositary oversight, standard risk warnings on financial promotions, increased disclosure of liquidity management tools and liquidity risk contingency plans;
- A new requirement that NURSs must suspend dealing in fund units where the standing independent valuer ("**SIV**") expresses material uncertainty regarding the value of 20% of the scheme property. In stressed market conditions, less liquid assets can suffer from a high degree of valuation uncertainty and become harder to sell at the value which would be expected in normal market conditions. The FCA will, however, allow an authorised fund manager ("**AFM**") to continue to deal where they have agreed with the fund's depositary that this is in the fund investors' best interests. This change is being introduced to ensure that AFMs (in conjunction with depositaries) have the ultimate say in whether a fund suspends. This will reduce reliance upon the SIV, and protect consumers by avoiding suspension where this would not be in investors' interests;
- A new rules where AFMs managing NURSs choose not to manage the liquidity mismatch directly, for example by adapting the redemption arrangements to be more similar to the liquidity of the underlying assets, the fund will have to be classified as a FIIA and become subject to the additional requirements this brings.

The FCA will not proceed with two of its original proposals, being (i) the requirement for a manager of a FIIA to add an 'identifier' to the name of the fund; and (ii) guidance relating to limiting the accumulation of large cash buffers within NURSs and UCITS funds.

In December 2019, the Bank of England published its Financial Stability Report, which set out the Bank's concerns regarding open-ended funds that invest in illiquid assets. The report states that there should be a greater consistency between the liquidity of a fund's assets and its redemption terms. In that regard, the Bank made a number of recommendations, including that (i) redeeming investors should receive a price for their units that reflects the discount needed to sell the required portion of a fund's assets in the specified redemption notice period; and (ii) that redemption notice periods should reflect the time needed to sell the required portion of fund assets without discounts beyond those captured in the price received by redeeming investors.

NEW SWISS FUND DISTRIBUTION REGIME WHICH MAY AFFECT YOUR FUTURE MARKETING AND DISTRIBUTIONS TO SWISS INVESTORS

From 1 January 2020, the Swiss Financial Services Act ("**FinSA**") and the Swiss Financial Institutions Act

("**FinIA**") came into force (with various transitional periods applicable). Under the new regime, the requirement to appoint a Swiss representative and a Swiss paying agent (only applicable to non-regulated qualified investors in Switzerland) will fall away. As our clients more commonly see distributions to regulated qualified investors, this is not a significant change. There are, however, many other changes being intorduced which may have an impact on future distributions. Furthermore, there will be further implementing provisions, the drafts of which having not yet been published.

Our understanding is that the new regime will abolish the entire current concept of "distribution" (which will be replaced by the one of "offer"). The current investor segmentation (regulated qualified investor/non-regulated qualified investor/retail investor) will be maintained but new client classifications are also being brought in (institutional/professional/retail). There has been uncertainty as to what extent and under what circumstances, fund distribution activities will be characterised as "financial services" under the new regime. Should such distribution of collective investment schemes be viewed as being not only an "offer", but also a "financial service", it will imply those marketing the fund having to comply with new obligations for client advisors of financial service providers to become registered in a Client Advisors Register and to comply with new conduct and organisational requirements.

As this is an ongoing development, it would be prudent to consult with Swiss counsel on potential distributions in a timely manner.

2 RECAP: WHAT YOU MAY HAVE MISSED

ILPA ISSUING ITS FIRST EVER MODEL FORM LIMITED PARTNERSHIP AGREEMENT

The Institutional Limited Partners Association ("**ILPA**") has published its first model limited partnership agreement (the "**Model LPA**"), based on ILPA Principles 3.0. The agreement applies to Delaware law-based partnerships operating "whole of fund" waterfall arrangements and can be used for traditional private equity buyout funds. Sections of the document can also potentially be inserted into existing LPAs upon agreement of the parties.

Additional versions of the Model LPA, including one based on a "deal-by-deal" waterfall, are planned for the future.

ILPA UPDATING ITS GUIDANCE ON BEST PRACTICES AND PRINCIPLES

In June 2019, the Institutional Limited Partners Association ("**ILPA**") has released an updated version (version 3.0) of its private equity principles, setting out its recommendations for private equity fund best practices and principles ("**ILPA Principles 3.0**" or the "**Principles**"), which are available on ILPA's website. The aim of the Principles is to encourage discussions between limited partners ("**LPs**") and general partners ("**GPs**") of private equity funds regarding key terms applicable to such funds.

ILPA PRINCIPLES

The updated Principles are far more detailed than previous iterations and address a number of new and emerging issues.

The updated Principles are far more detailed than previous iterations and address a number of new and emerging issues (some through incorporation of separate ILPA publications), including co-investments, ESG integration, GP-led secondary transactions and conflicts of interest arising from parallel vehicles and cross-fund investments, as well as expanding and clarifying existing guidance.

One particular point of interest is in relation to clawbacks. ILPA states that clawbacks should, ideally, be paid gross, rather than net, and paid back no later than two years following recognition of the liability. This marks a departure from previous guidance and from current market norms. The first version of the principles stated clawback amounts should be gross of taxes paid, but this was switched to a net-of-tax recommendation for version 2.0 following feedback from GPs. ILPA does go on to say that where it is excessively burdensome or impractical to require clawback gross of tax, the hypothetical marginal tax rates applied in calculating clawbacks on a net basis should reflect the actual marginal rate that would apply to the individual members of the GP impacted.

Whilst adherence to the Principles is not required (with the Principles stating that they are not to be treated as a compliance checklist, as each fund should be considered separately and holistically), they nevertheless indicate LP's preferred approach to key fund provisions. As such, GPs and LPs alike should familiarise themselves with the ILPA Principles 3.0 and GPs should be aware that LPs may require explanatory information where a GP intends to deviate from the Principles.

INDUSTRY GUIDANCE, RELATING TO GP-LED SECONDARY FUND RESTRUCTURINGS, WAS PUBLISHED TO ENCOURAGE PRODUCTIVE DIALOGUE BETWEEN GENERAL AND LIMITED PARTNERS

In April 2019, ILPA published its first set of recommendations for LPs and GPs to consider when participating in a GP-led secondary fund restructuring, "GP-led Secondary Fund Restructurings: Considerations for General and Limited Partners" (the "**ILPA Secondaries Guidance**" or the "**Guidance**") (a summary of which is contained in the ILPA Principles 3.0). The guidance was published in response to the increasing prevalence of GP-led secondary transactions which has been raising questions for many LPs. The aim of the guidance is to encourage productive dialogue and foster more informed decision-making by LPs.

The **ILPA Secondaries Guidance** covers the following key areas:

- ***LP engagement and the role of the LP Advisory Committee*** ("**LPAC**"); the Guidance envisages an enhanced oversight role for the LPAC on GP-led secondary transactions, both before the process is launched to LPs and during its negotiation. GPs should engage the LPAC as the forum for driving the transaction and clearing issues. LPAC members whose organisations are participating in the transaction as bidders should disclose their interest and recuse themselves from formal deliberations, voting on the transaction and/or waiving any conflicts of interest;
- ***Adequate disclosure of information***; the Guidance includes a list of disclosures the GP should make to the LPAC and to LPs and the timing of such disclosures;
- ***Key terms;*** GPs should provide existing LPs with a 'status quo' option in which an LP can elect to roll over its fund interest from the existing fund into the new fund with no change in economic terms. Where an LP does not respond to an election from the GP in relation to the GP-led restructuring, the election for such LP should be treated as an election to participate in the new fund with no change in economic terms (rather than being treated as an election to sell). Where there is follow-on capital in the new fund, LPs who have elected to roll into the new fund should not be compelled to make follow-on capital available and any resulting dilution of existing LPs should be effected on a fair and reasonable basis;
- ***Allocation of fees and expenses;*** allocation of transaction expenses should be disclosed in full and allocated according to which parties will benefit from the proposed transaction;
- ***The role of third-party advisors;*** *the* Guidance includes guidance in relation to the appointment of financial advisors by GPs, independent advisors appointed by the LPAC and independent fairness opinion providers appointed by selling LPs;
- ***Steps for LPs to take when engaging in a GP-led process;*** the Guidance suggests certain internal protocols that existing LPs should adopt when asked to participate in a transaction of this type.

Given the highly unique nature of these transactions and broad range in the scope of deals, ILPA states that its Guidance may not be universally appropriate or applicable to every circumstance.

THE PUBLICATION OF GUIDANCE TO ASSIST INVESTMENT MANAGERS AND GENERAL PARTNERS TO INTERPRET AND APPLY THE EXISTING CORPORATE TRANSPARENCY AND BENEFICIAL OWNERSHIP RULES (CLLS Q&A ON THE PSC REGIME)

The Law Society and the City of London Law Society have published a jointly produced series of Q&As regarding the PSC regime. The Q&As aim to highlight particular complexities that are not specifically addressed by either the legislation governing the PSC regime or the associated BEIS guidance.

CLLS Q&A ON PSC REGIME

The Q&As include some useful, technical guidance relating to limited partnership fund structures.

Whilst English limited partnerships are not themselves within the scope of the PSC regime, the Q&As include some useful, technical guidance relating to how the PSC rules apply to investment managers, GPs and LPs within limited partnership fund structures; including (i) where management rights in relation to an investment in a UK company, which are held by the general partner, have been delegated to an investment manager, the Q&A considers whether either, or both, the general partner and the investment manager should be registered on the PSC register; and (ii) in relation to the interpretation of the PSC legislation with regards to limited partners; whether the interests of multiple funds with the same manager/general partner should be aggregated for the purposes of the rules.

THE PUBLICATION OF THE ANNUAL REPORT (BY THE PRIVATE EQUITY REPORTING GROUP) ON DISCLOSURE AND TRANSPARENCY AND GOOD PRACTICE REPORTING BY THE PRIVATE EQUITY INDUSTRY

In December 2019, the 12th edition of the annual report by PERG, the Private Equity Reporting Group, the body set-up in 2008 to monitor openness and transparency in the private equity industry and measure compliance with the Walker Guidelines, was published. Each year, a sample of approximately a third of portfolio companies that fall within the scope of the guidelines are reviewed for compliance with the disclosure requirements.

The 2019 report contains the results of a review of 55 portfolio companies that fall within the scope of the guidelines and the 47 private equity firms (including those operating in a private equity-like manner) that back them.

The key findings of the 2019 report are:

- 100% compliance against disclosure requirements in the sample of portfolio company annual reports reviewed (2018: 100%).
- 53% of the sample reviewed achieved at least a good rating, down from 73% in 2018, though one company produced excellent disclosures (2018: none).
- 80% of portfolio companies have published an annual report in a timely manner on their website (2018: 81%). 68% of portfolio companies published a mid-year update on their websites in a timely manner (2018: 74%).

Alongside the annual report, the PERG and PwC published the latest version of the Good Practice Reporting Guide for portfolio companies. The guide has been updated following a review of portfolio company disclosures in 2019 and highlights examples of good practice in order to aid portfolio companies with their narrative reporting in the following year.

THE PUBLICAITON (BY THE COST TRANSPARENCY INITIATIVE) OF TEMPLATES AND TOOLS FOR INSTITUTIONAL INVESTORS TO RECEIVE STANDARDISED COSTS AND CHARGES INFORMATION

In May 2019, the Cost Transparency Initiative ("**CTI**") published templates and tools for instituional investors to receive standardised cost and charges information to institutional investors from asset managers. The new templates can be used by institutional investors to access and assess critical information on costs. This gives investors clear expectations for standardised disclosure and should allow comparison of charges between providers.

The main account template covers the majority of assets and product types. It can also collect data in one place from other sub templates, for specific asset classes. The private equity sub-template (which can be used together with the main account template or as a standalone) is a sub-template aimed at specific types of investment. It may also be used for private debt where appropriate. Along with the templates, CTI has also published guidance for pension schemes and their advisers on how to make use of cost information, and for asset managers on how to provide cost information to their clients. The CTI says that the format of the templates is for illustrative purposes only and that institutional investors should discuss with their managers/consultants/investment advisers what format they want.

The CTI is an independent group working to improve cost transparency for institutional investors with the responsibility for progressing the work already undertaken by the Institutional Disclosure Working Group ("**IDWG**"). The CTI is supported by Pensions and Lifetime Savings Association, Investment Association and Local Government Pension Scheme Advisory Board. The IDWG was set up to support consistent and standardised disclosure of costs and charges to institutional investors.

The new templates have been welcomed by the FCA, although it makes the point that they have not been specifically on creating a method of delivering compliance with MiFID and other requirements.

A REFINED APPROACH TO THE PREPRATION, AND PUBLISHING, OF PROSPECTUSES INTRODUCED ACROSS THE EU

The Prospectus Regulation is now in force and replaces the previous regime in its entirety. Whilst the new regime feels familiar, there are a number of new provisions and, in the case of the prospectus' risk factors and summary sections, a wholly new approach has been taken.

Some key points relating to the new regime include:

- All of the provisions of the Prospectus Regulation have come into effect. In the UK, the FCA has incorporated the regulation's provisions in a new 'Prospectus Regulation Rules' chapter of the FCA Handbook;
- The summary section of a prospectus must now be in a Q&A format, limited to seven sides of paper. Where a comprehension alert is required under the PRIIPs Regulation in the fund's KID, the same alert must be included in the prospectus summary;
- Issuers, in conjunction with their sponsors and advisers, will need to conduct an internal assessment to identify the most material risk factors. Issuers should be prepared for competent authorities to raise more queries in relation to the risk factors section;
- The Annexes detailing the specific content requirements of a prospectus have been rewritten, although there are not many substantive differences; and
- Reduced disclosure regimes have been introduced for secondary issues and, for frequent issuers, by way of a Universal Registration Document. It is not expected these will be frequently used.

It is important to note that certain ESMA guidance is still relevant. In July 2019, ESMA published a consultation on the draft guidelines on disclosure requirements under the Prospectus Regulation. The draft guidelines apply to competent authorities and market participants and aim to help market participants comply with the disclosure requirements set out in the Delegated Regulation on the format, content, scrutiny and approval of prospectuses and to enhance consistency across member states in the way the annexes to the Commission Delegated Regulation are interpreted. The content of the draft guidelines generally follows the content of the CESR recommendations. The consultation closed in October 2019. ESMA expects to publish a final report containing a summary of all consultation responses and a final version of the guidelines in Q2 2020.

In October 2019, ESMA published the final version of its guidelines for competent authorities relating to risk factors (in materially the same form as previously published in draft form in March). The guidelines have applied since 1 December 2019.

New ESMA Q&As have also been introduced and ESMA published an updated version of its old Prospective Directive Q&As in July 2019 where certain Q&As were added, removed and/or updated. ESMA will continue to analyse the Q&As in relation to the Prospectus Directive to determine whether to update and carry them forward or not.

A detailed analysis of how the Prospectus Regulation applies to investment funds can be found in our Briefing published earlier this year, available here.

NEW RULES ON DIRECTORS' REMUNERATION AND RELATED PARTY TRANSACTIONS TO CREATE PARALLEL DISCLOSURE OBLIGATIONS TO THE LISTING RULES REGIME, PLUS NEW OBLIGATIONS FOR SFS LISTED FUNDS

In June 2019, new rules implementing the Shareholder Rights Directive II ("**SRD II**") came into force. Funds with shares trading on the Specialist Funds Segment may have new requirements due to the new rules. There are two key areas of change that are relevant to listed investment funds:

Changes to the regime relating to directors' remuneration

The key changes, which are set out in the government's explanatory memorandum, relate to the scope of companies and officers caught by the regime and the content requirements for a company's remuneration report and remuneration policy. Companies preparing to put forward a new remuneration policy this year should note in particular the changes to content requirements.

Shareholders Rights Directive: The key changes relating to remuneration are:

- ***Change in scope of "directors" covered:*** A company's remuneration policy and report will cover any person not on the board of directors who carries out the function of chief executive officer or deputy chief executive officer (regardless of title).
- ***Approval of inconsistent payments:*** The provisions that previously allowed a payment which was inconsistent with the remuneration policy to be made pursuant to an ordinary resolution of the company will now require an amendment to the remuneration policy (also an ordinary resolution).
- ***Requirement to put forward a new policy:*** Where a remuneration policy is put forward at a general meeting but is not approved, the company must put forward a new policy at the next general meeting. The last approved policy will remain in place until a new one is approved.
- ***Remuneration policy content requirements:*** The remuneration policy will be required to include:
  - details of any deferral periods in relation to any element of a remuneration package;
  - details of any vesting periods and any holding periods in relation to share-based remuneration;

- the duration of contracts or arrangements with directors;
- an explanation of the decision-making process for its determination, review and implementation and measures to avoid or manage conflicts of interest; and an explanation and description of all significant changes compared to the previous policy.

- ***Remuneration report content requirements:*** The directors' remuneration report will be required to include:
  - the total fixed and variable remuneration for each director (in the "single total figure" table);
  - any change to the exercise price or date of any options;
  - the annual percentage change in remuneration over the five financial years preceding the relevant financial year in respect of each director, compared with the average annual percentage change for employees of the company on a full time equivalent basis (currently the regulations require a comparison of the CEO's remuneration against average employee remuneration since the previous year with the option to use a comparator group); and
  - any deviation there may have been from the procedure set out in the company's remuneration policy for determining directors' remuneration.
- Remuneration reports must not contain certain types of sensitive personal data (such as racial or ethnic origin or sexual orientation).
- ***Availability of reports:*** Remuneration reports will need to be retained on a company's website for 10 years (and may be retained for longer if they do not include personal data). The date and results of the vote on a remuneration policy will need to be retained on the website for as long as it is applicable.

SFS funds are required to have auditors review certain sections of the remuneration report.

Changes to the related party regime

In order to comply with the requirements of SRDII in relation to related party transactions, a parallel Related Party Transactions regime has been established under the Disclosure Guidance and Transparency Rules ("**DTRs**"), which applies to all companies admitted to an EU regulated market (including those traded on the Specialist Funds Segment). This regime is less onerous than the Listing Rules regime, which currently applies to premium listed companies, in that only announcement and board approval of related party transactions, rather than shareholder approval, are required. In most cases, for premium listed companies, compliance with Listing Rule 11 will suffice for compliance with both regimes. However, as the DTRs apply the IAS definition of a "Related party", which is different to the Listing Rules definition, in cases where a transaction does not fall within Listing Rule 11, companies will need to consider whether it constitutes a related party transaction for the purposes of the DTRs.

AIFM responsiblities

The SRDII also contains rules applying to AIFMs. Full-scope AIFMs must develop and disclose a shareholder engagement policy, describing how the AIFM integrates shareholder enegement in its investment strategy. The AIFM must also disclose, on an annual basis, how the shareholder engagment policy has been implemented, a general description of its voting behaviour (explaining the most significant votes) and its use of proxy services. AIFMs must also disclose information on the transaprency of its acitivities.

POTENTIAL FOR UK WITHHOLDING TAX IN RESPECT OF FEE REBATE ARRANGEMENTS, FOLLOWING A RECENT TRIBUNAL DECISION

On 9 August 2019 the Upper Tribunal delivered its decision in the case of The Commissioners for HM Revenue & Customs v Hargreaves Lansdown Asset Management Limited. The tribunal held that the "loyalty bonuses" paid to investors by Hargreaves Lansdown Asset Management Limited (HL) were taxable income of investors in relation to which HL was potentially required to withhold tax. The bonuses were structured as "fee rebates"/"trail commissions", in that they were ultimately funded by the fund managers from their annual management charges.

For more on this development please see our briefing Asset management tax: what to know for the new autumn term.

THE IMPLICATIONS OF REVISIONS TO EU-WIDE DERIVATIVES LEGISLATION (EMIR 2.1) FOR AIFS

In June 2019, the main derivatives regulation in the EU, the European Market Infrastructure Regulation on OTC derivative transactions, central counterparties and trade repositories (Regulation EU 648/2012) ("**EMIR**") was amended, and is now referred to in the market as "EMIR 2.1". EMIR 2.1 is intended to reduce certain of the burdens and costs associated with complying with the requirements of EMIR. EMIR 2.2, a separate amendment not covered in this briefing, makes certain changes the way in which central counterparties are supervised under EMIR.

Under EMIR 2.1 the definition of financial counterparty ("**FC**") has been broadened to include all EEA AIFs,

whether or not they are managed by a manager authorised or registered under AIFMD. Previously, EEA AIFs that were not managed by a manager authorised or registered under AIFMD were categorised as non-financial counterparties ("**NFCs**").

In May 2019, the International Swaps and Derivatives Association ("**ISDA**") released an explanatory note on the expansion of the scope of the definition of AIFs that will be classified as FCs, however the position under EMIR 2.1 can be summarised as follows:

- EEA or non-EEA AIFs whose manager is authorised under AIFMD are FCs (as they were under EMIR);
- EEA AIFs whose manager is not authorised under AIFMD were NFCs but are now FCs; and
- Non-EEA AIFs managed by a non-EEA manager were deemed NFCs but are now deemed FCs (when facing EEA brokers/banks).

Implications for Funds

The key implication of the reclassification of certain AIFs as FCs (or deemed FCs) is that NFCs are generally not required to exchange collateral as variation margin or mandatorily to clear any derivatives transactions. FCs are however required to exchange collateral as variation margin in respect of most uncleared derivatives transactions on a daily basis and, depending on the product, clear certain derivatives transactions.

These requirements also apply to NFCs with significant derivatives exposures for non-hedging purposes, which are known as "NFC+s".

A small number of product-specific exemptions apply. For example physically-settled FX forwards and physically-settled FX swaps are carved out of the requirement to exchange collateral as variation margin. Separately, a new category of "small FCs" provides a derogation from the clearing obligation (but not the variation margin requirements for uncleared derivatives transactions) for some AIFs. Please refer to our previous *client Note* for more detail on small FCs.

Managers of AIFs who use, or may use, derivatives should think carefully about their EMIR classification. If an AIF that was previously and NFC has been reclassified as an FC, the increased cost, complexity and operational burden of collateralising/clearing derivatives transactions may incentivise the manager to enter into such derivative transactions elsewhere in the fund structure. Alternatively, there may be commercial, tax or operational reasons why the manager wants to continue to enter into derivatives transactions at the level of the FC. Either way, there are ways we can assist you with planning, structuring and regulatory optimisation as well as with any amendments required to your contractual arrangements.

EUVECA REGIME: CLARIFICATION OF CONFLICT OF INTEREST RULES GOVERNING EUVECA MANAGERS

In December 2019, a Delegated Regulation ((EU) 2019/820) supplementing the EuVECA Regulation came into force. The changes made pursuant to the Delegated Regulation relate solely to the provisions relating to conflicts of interest. The changes clarify the conflicts of interest rules governing EuVECA managers and what measures should be taken by EuVECA managers to prevent, manage and monitor conflicts of interest. The changes also provide for the management of consequences of conflicts of interest, strategies for the exercise of voting rights to prevent conflicts of interest and the disclosure of conflicts of interest.

The European Commission is scheduled to review the EuVECA Regulation by March 2022.

ELECTRONIC SIGNATURES: LENGTHY LAW COMMISSION REVIEW CONCLUDES THEY ARE VALID, EVEN FOR DEEDS

In September 2019, the Law Commission published a Report and Summary Document setting out a statement of the law regarding the validity of electronic signatures, and making further recommendations for this area going forward. This report follows its consultation paper published in August 2018. The report sets out a "Statement of the Law" regarding electronic signatures (see below) along with various recommendations for future work in this area.

The "Statement of the Law" (summarised below) applies both where there is a statutory requirement for a signature and where there is not. It has broad application and is not restricted to commercial and consumer documents.

- An electronic signature is capable in law of being used to execute a document (including a deed) provided that (i) the person signing the document intends to authenticate the document and (ii) any formalities relating to execution of that document are satisfied;
- Such formalities may be legislative, contractual, or may be laid down in another private law instrument under which a document is to be executed;
- An electronic signature is admissible in evidence in legal proceedings;
- Save where the contrary is provided for in relevant legislation, contractual arrangements, or case law, the common law adopts a pragmatic approach and does not prescribe any particular form or type of signature. The courts will adopt an objective approach considering all the surrounding

circumstances when determining whether the method of signature adopted demonstrates an authenticating intention;

- The courts have, for example, held that the following non-electronic forms amount to valid signatures: (a) signing with an 'X'; (b) signing with initials only; (c) using a stamp of a handwritten signature; (d) printing of a name; I signing with a mark, even where the party executing the mark can write; and (f) a description of the signatory if sufficiently unambiguous;
- Electronic equivalents of these non-electronic forms of signature are likely to be recognised by a court as legally valid;
- The courts have, for example, held that the following electronic forms amount to valid signatures in the case of statutory obligations to provide a signature where the statute is silent as to whether an electronic signature is acceptable: (a) a name typed at the bottom of an email; (b) clicking an "I accept" tick box on a website; and (c) the header of a SWIFT message; and
- The Commission's view is that the current legal requirement that a deed must be signed 'in the presence of a witness' requires the physical presence of that witness and does not allow for 'remote' witnessing of documents, for example, by video link. This is the case even where both the person executing the deed and the witness are executing or attesting the document using an electronic signature.

ELECTRONIC SIGNATURES

Electronic signatures are valid for executing documents, including deeds, provided that the person signing the document intended to authenticate it and any formalities relating to execution are satisfied.

3 SPOTLIGHT: ON YOUR RADAR

A FOCUS BY THE EUROPEAN REGULATOR ON THE APPLICATION OF THE MARKET ABUSE REGIME TO COLLECTIVE INVESTMENT UNDERTAKINGS

In October 2019, ESMA published a consultation paper on the Market Abuse Regulation ("**MAR**") covering a range of issues.

By way of background, the European Commission is required, under Article 38 of MAR, to submit a report to the European Parliament and the Council of the EU to assess various provisions of MAR. In March 2019, it formally requested technical advice from ESMA on the report (the "**Commission's Mandate**"). ESMA is consulting in response to this request. The consultation covers the topics included under Article 38 of MAR, together with a set of additional elements arising out of the Commission's request to ESMA. In addition, it incorporates several other issues ESMA has identified as closely linked to some of these topics and connected elements, which ESMA considers should be addressed jointly.

The consultation includes a chapter focussing on collective investment undertakings ("**CIUs**") (notwithstanding the fact that the Commission's Mandate refers to all CIUs, ESMA considers the consultation to be of relevance to only those CIUs admitted to trading or trading on a trading venue). ESMA acknowledges that there might be elements making the application of MAR to CIUs vis-à-vis other issuers more difficult: the fact that a significant number of CIUs do not have legal personality, and the role played in CIUs by external companies (e.g. management companies, asset managers, depositaries), the specificities of CIUs in terms of investment strategies and the determination of net asset value (both for CIUs with and without personality), has led ESMA to analyse whether it is necessary to apply the MAR provisions for issuers to them.

ESMA is therefore seeking opinions as to whether there is a need for MAR to be amended to explicitly include or exclude CIUs in respect of the following:

MAR ESMA CONSULTATION

ESMA's preliminary view is that there are grounds to consider that MAR should explicitly include PDMR obligations for CIU management companies.

PDMR obligations

In its mandate, the Commission stated that the definition of a person discharging managerial responsibilities ("**PDMR**") might raise some doubts as to whether it is capable of covering managers in external management companies managing investment funds without a legal personality. The same logic applies to investment funds with a legal personality managed externally. The Commission therefore asked ESMA to assess whether there is a need for the managers of management companies to be covered by the requirement to disclose their transactions and how to best adapt the scope of that requirement to ensure a level regulatory playing field between different management structures. ESMA has identified three areas to consider in respect of this:

- ***The need to explicitly cover PDMR obligations to management companies of CIUs:*** ESMA's preliminary view is that there are grounds to consider that MAR should explicitly cover PDMR obligations to CIUs and their management companies:
- ***The identification of the individuals who should be captured by PDMR obligations:*** ESMA suggests that, were the PDMR obligations explicitly extended to CIUs, there would be two types of PDMRs (i) the individuals that currently meet the definition of PDMR as they are genuinely 'within the issuer', e.g. as members of the administrative body of an investment company; and (ii) the 'relevant persons' (the definition of which would mirror the definition in the UCITS Directive) from the management company (or from external service providers acting for the CIU in question). Further, were the PDMR obligations to be extended, ESMA has not found any reason to exclude 'closely associated persons' from the scope of the PDMR obligations. ESMA also asks for views on whether entities other than the asset management company (e.g. depositaries) and other entities on which the CIUs has delegated the execution of certain tasks should be captured by the PDMR regime; and
- ***The revision of the financial instruments that determine the scope of PDMR obligations:*** ESMA agrees with the analysis made by the Commission that a strict reading of Article 19(1)(a) leads to the conclusion that it does not apply to CIUs issuing units, because this Article only refers explicitly to shares and debt instruments. To avoid creating an unlevel playing field between those that issue shares and those that issue units, were the PDMR obligations to be extended Article 19(1)(a) should be amended to expressly refer to units.

Disclosure of inside information

In March 2019, ESMA clarified in a Q&A that the disclosure obligation of Article 17 of MAR also applies to financial instruments admitted to trading or traded on a trading venue issued by a CIUs without legal personality, which is considered for these purposes as the 'issuer'. ESMA also clarified that the management company managing the CIU could be held responsible for a potential infringement of the CIU's obligation to disclose inside information under Article 17 of MAR.

However, the preparatory analysis carried out by ESMA for the Q&A made clear that in some Member States it might be difficult to enforce these obligations due to the lack of legal personality of the issuer. Consequently, ESMA is seeking views on the need for amending Article 17 of MAR to ensure the disclosure of inside information by CIUs without legal personality. ESMA's preliminary view is that the management company should be responsible for the publication of inside information, with the other entities involved responsible for reporting to it any information that might be of relevance immediately.

Insider lists

ESMA's preliminary view is that the MAR provisions on insider lists equally apply to CIUs and that there is no need to further amend Article 18 of MAR in this respect, but it is seeking views on whether specific obligations are needed for 'elaborating' insider lists related to CIUs.

PDMR notifications: de-minimis thresholds

Elsewhere in the consultation, ESMA seeks views on the de-minimis thresholds relating to PDMRs and PCAs notification requirements. MAR currently provides that no notification obligation applies where the financial instrument concerned by the relevant transaction is a unit or share in a CIU in which the exposure to the issuer's shares or debt instruments does not exceed 20% of the assets held by the collective investment undertaking. MAR further provides that the notification obligation does not apply to transactions concerning financial instruments which have exposure to a portfolio of assets in which the exposure to the issuer's shares or debt instruments does not exceed 20% of the portfolio's assets. These provisions were brought in on 1 January 2018; ESMA is seeking views as to whether the thresholds are appropriate or not.

A wide range of other issues are covered in the consultation including:

- The appropriateness of introducing common rules on the need for all Member States to provide for administrative sanctions for insider dealing and market manipulation;
- The definition of inside information;
- The appropriateness of trading prohibitions for PDMRs;
- The possibility for establishing an EU framework for cross-market order book surveillance in relation to market abuse; and
- The scope of the benchmark provisions.

DRAFT NEW GUIDELINES ON OPEN-ENDED PERFORMANCE FEES MAY BE EXTENDED TO ALSO APPLY TO AIFS

In July 2019, ESMA published a consultation paper in respect of draft guidelines on performance fees (the "**Performance Fee Guidelines**") applicable to undertakings for collective investments in transferable securities ("**UCITS**").

Whilst the purpose of the consultation is to harmonise regulations relating to UCITS performance fees across the EU, the consultation also asked if the guidelines should also be applicable to AIFs marketed to retail investors in order to ensure equivalent standards in retail investor protection. In its consultation response, the AIC states that it does not agree with this proposal, stating *"it is the role of the board to oversee the investment company and to ensure that the investment manager and other service providers are appropriately remunerated. Commercial fee negotiations are a matter of judgement for the board. It is not the role of the regulator to set parameters around these negotiations or to provide guidelines to standardise the remuneration model used to incentivise investment managers to generate greater returns for shareholders"*. The consultation ended on 31 October 2019. ESMA states that it will consider the feedback received during Q4 2019, with a view to finalising the guidelines for publication afterwards.

SOME NEW DISCLOSURE RULES RELATING TO CLIMATE CHANGE TO BE BROUGHT IN BY THE FCA

In October 2019, the FCA published its Feedback Statement on Climate Change and Green Finance (FS19/6). The Feedback Statement sets out next steps, rather than including any draft rules.

The main areas of interest to investment funds are:

- ***Issuer' climate change disclosures:*** in early 2020, the FCA will publish a consultation paper proposing new disclosure rules for certain issuers at least initially, on a 'comply or explain' basis, and clarify existing disclosure obligations relating to climate change risk. The rules will be aligned with the Financial Stability Board's Taskforce on Climate-related Financial Disclosures recommendations, which the FCA state are widely regarded as providing a useful framework for climate-related

financial disclosures. No details are provided on which categories of issuers will fall within scope of the new rules;

- ***Regulated firms' climate change disclosures:*** the FCA will consider how best to enhance climate related disclosures by regulated financial services firms that fall outside the scope of its proposed new rules for certain listed issuers;
- ***Framework for effective stewardship:*** the FCA published a Discussion Paper earlier in the year, jointly with the FRC, calling for more strategic input on how best to encourage the institutional investment community to engage more actively in stewardship of the assets in which they invest. The FCA will publish a feedback statement in the coming weeks in response. This work builds on regulatory measures that took effect in June this year, aligned with SRD II. These measures set requirements for asset managers to disclose their shareholder engagement policies and investment strategies, including in relation to climate change and other ESG factors; and
- ***Expectations around green financial products and services:*** the FCA has carried out diagnostic work that indicates that the 'sustainable' label is applied to a very wide range of products and, on the face of it, some of these do not appear to have materially different exposures to products that do not have such a label (often referred to as 'greenwashing'). The FCA plans to carry out further analysis on greenwashing and challenge firms when it identifies potential greenwashing.

UPCOMING AMENDMENTS TO THE FCA'S TECHNICAL GUIDANCE APPLICABLE TO LISTED FUNDS

In October 2019, the FCA published its 24th Primary Market Bulletin, which included consultations on:

- A proposed new technical note, "*Class testing changes to an investment management agreement where there are unquantifiable benefits*", to clarify its approach where the benefit of the transaction is unclear and class tests difficult to apply; and
- The amendment of its technical note, *"Master-feeder structures"*, to clarify that where the applicant is the only feeder into a master fund, LR 15.2.6R (Feeder funds) (and LR 15.4.6R (Feeder funds) on a continuing basis) will not apply, and the full eligibility requirements for LR 15 (Closed-Ended Investment Funds: Premium listing) must be met.

The consultation ended in November 2019.

The following changes were also being made to the Knowledge Base:

- Technical note "*Compliance with the Listing Principles and Premium Listing Principles*" has been finalised without further changes;
- Procedure Note *"UKLA standard comments"* has been deleted;
- Procedure Note "*Primary Markets Oversight and Listing Transactions – decision making and individual guidance process*" has been finalised without further changes;
- A new Procedure Note *"Sponsor Service Enquiry Line"* has been finalised as previously consulted upon; and
- A new Procedure Note *"Schemes of Arrangement"* has been finalised as previously consulted.

In September 2019, the FCA published its Quarterly Consultation No.25 (CP19/27) which, among other things, proposed amendments to the AIFMD forms in relation to notifications made by UK AIFMs. The new forms came into use from 1 January 2020. The changes to the forms are:

- A new postal address for forms (to reflect the new FCA address):
- The removal of the tick box for firms to confirm they have read and understood the declaration to make the process more efficient (firms will still have to complete and sign the form to confirm they have understood the declaration);
- Changes to the layout and general style of the form;
- Updates to data protection wording; and
- Updates to FCA guidance hyperlinks.

In the Quarterly Consultation, the FCA also proposed making an amendment to the rules relating to PAIFs. The existing rules require the authorised fund manager of a PAIF to take reasonable steps to ensure that no body corporate holds more than 10% of the net asset value of that fund. The FCA proposes to align the text with the underlying tax regulations by clarifying that a body corporate may have an indirect interest in a PAIF of more than 10% where certain conditions are met.

A REVISED CORPORATE GOVERNANCE AIC CODE TO APPLY TO LISTED FUNDS FROM 2020

In February 2019, the Association of Investment Companies ("**AIC**") published a revised version of its code of corporate governance (the "**Revised AIC Code**" or "**Code**"). The Revised AIC Code will apply in respect of accounting periods beginning on or after 1 January 2019.

The key changes made in the Revised AIC Code are:

Chairman tenure

The Revised AIC Code does not include a limit on chair tenure (this is a departure from the 2018 UK FRC Code which includes a nine-year limit). Instead, the Revised AIC Code states that a board should determine and disclose a policy on the tenure of the chair. A clear rationale for the expected tenure should be provided, and the policy should explain how this is consistent with the need for regular refreshment and diversity.

Board composition and independence

There is a new requirement that at least half the board, excluding the chair, should be non-executive directors whom the board considers independent. The Code includes circumstances considered not independent – this list of circumstances now includes where a director has served on the board for more than nine years from the date of his or her first appointment.

The Chair should be independent, now stated to be as at appointment. Where any of these or other relevant circumstances apply, and the board nonetheless considers that the non-executive director is independent, a clear explanation should be provided.

Board appointments

The Revised AIC Code states that advertising and/or an external search consultancy should generally be used.

Directors overboarding

Previously, Directors were required to ensure that they could devote sufficient time to the fund to carry out their duties effectively. The Code now required boards to take into account other demands on directors' time when making new appointments and for significant commitments to be disclosed. Additional external appointments should not be undertaken without prior approval of the board, with the reasons for permitting significant appointments explained in the annual report.

Directors' re-election

All directors should be subject to annual re-election. A fund's Articles of Association may need to be changed at the next suitable opportunity to reflect this, although funds will be expected to follow the new provision even if his or her articles have not yet been amended.

Board evaluation

The Code contains a list of those that should be subject to a formal and rigorous annual evaluation of performance (being the board, committees and individual directors) which has been expanded to include the Chair. The Chair should also consider having a regular externally facilitated board evaluation (the provision that FTSE 350 companies should have this at least every three years has been retained. A fund's annual report should explain (i) how the board evaluation has been conducted; (ii) the nature and extent of an external evaluator's contact with the board and individual directors; (iii) the outcomes and actions taken; and (iv) how it has or will influence board composition. The Code also requires the Chair to act on the results of the evaluation by recognising the strengths and addressing any weaknesses of the board. Each director should engage with the process and take appropriate action when development needs have been identified.

Audit committees

The Revised AIC Code allows the chair of the board to sit on the audit committee. Again, this departs from the 2018 UK FRC Code. The position remains that the chair of the board should not chair the committee but can be a member if they were independent on appointment. If the chair of the board is a member of the audit committee, the board must explain in the annual report why it believes this is appropriate.

Nomination committees

Previously, a nomination committee had to consist solely of independent directors. The Revised AIC Code relaxes this requirement by stating that a majority of members of the nomination committee should be independent.

Significant votes against a resolution

Where **20%** or more of votes have been cast against a board resolution:

- The fund should explain, when announcing voting results, what actions it intends to take to consult shareholders in order to understand the reasons behind the result;
- An update on the views received from shareholders and actions taken should be published no later than six months after the shareholder meeting; and
- The board should then provide a final summary in the annual report and, if applicable, in the explanatory notes to resolutions at the next shareholder meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.

This puts a specific figure on the previous concept of a 'significant' vote. This threshold reflects the figure used in the Investment Association's Public Register which provides details of significant votes against resolutions and related company updates.

Stakeholder engagement

The Code contains a new requirement that the board should understand the views of key stakeholders (other than those who have cast significant votes against resolutions).

A fund's annual report should contain a description of how his or her interests and the matters set out in s.172 of the Companies Act 2006 (the directors' duty to promote the success of the company) have been considered in board discussions and decision making. The board should keep engagement mechanisms under review to ensure they remain effective.

S.172 of the Companies Act 2006 applies only to UK domiciled companies. The Revised AIC Code clarifies, however, that the intention is that the matters contained in that section apply to all funds, irrespective of domicile, provided this does not conflict with local company law.

Diversity

A new requirement in the Code is that the annual report should describe the work of the nomination committee including "the policy on diversity and inclusion, its objectives and linkage to fund strategy, how it has been implemented and progress on achieving the objectives".

A REVISED STEWARDSHIP CODE TO APPLY TO LISTED FUNDS FROM 2020

In October 2019, the Financial Reporting Council ("**FRC**") published its revised Stewardship Code (the "**2020 Stewardship Code**") which will take effect on 1 January 2020 and will replace the UK Stewardship Code 2012. The 2020 Stewardship Code includes a new definition of 'Stewardship': "*Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries, which leads to sustainable benefits for the economy, the environment and society*". The 2020 Stewardship Code contains a set of 12 'apply and explain' principles for asset managers and asset owners, and a (new) separate set of six 'apply and explain' principles for service providers. Service providers include investment consultants, proxy advisors, and data and research providers.

As with the 2012 Stewardship Code, investment funds may choose to adhere to the best practice standards in relation to stewardship set out in the AIC Code, or to be signatories to the 2020 Stewardship Code.

CALLS FOR GREATER TRANSPARENCY IN PAYING DIVIDENDS

The Investment Association ("**IA**") has published a report calling for more transparency in the payment of dividends. The report looks at the prevalence of the practice of companies avoiding an annual shareholder vote on dividends by only declaring interim dividends.

Points to note:

- The report found that of the 628 listed companies examined, 22% of those that paid dividends (interim or final) during the relevant period did not seek shareholder approval for these distributions. A number of reasons were given for there being no corresponding shareholder resolution and the report recognises that there may be legitimate reasons and that making an annual vote mandatory may have an undesirable impact on certain companies and shareholders.
- The IA recommends that all listed companies should publish a distribution policy which sets out the company's long-term approach to making decisions on the amount, structure and timing of returns to shareholders, including dividends, share buybacks and other capital distributions, in order to promote a more transparent, long-term approach.
- The IA will establish a working group to develop best practice guidance on distribution policies and make recommendations to the government on whether a shareholder vote on such policy and/or on yearly distributions should be mandatory. It aims to publish policy guidance in the autumn.

REVISIONS TO THE FINANCIAL REPORTING COUNCIL'S ETHICAL AND AUDITING STANDARDS MAY MEAN AUDITORS OF CERTAIN PRIVATE EQUITY FUNDS CAN ONLY PROVIDE A LIMITED RANGE OF NON-AUDIT SERVICES TO THAT FUND

In July 2019, the Financial Reporting Council ("**FRC**") published a consultation paper seeking views on proposed changes to its Ethical and Auditing Standards. In its response to the FRC's consultation, the BVCA warned that some of the proposed changes could have unintended consequences. A key proposal is that auditors of a public interest entity ("**PIE**") could only provide a limited range of non-audit services to that PIE. The definition of PIE is broadly meant to cover publicly traded companies but would also include portfolio companies with listed loan notes. As a result, private equity funds could only procure very limited other services from any accounting firm which provides audit services to any of its portfolio companies or the fund itself. Neither corporate finance advice nor due diligence services are included in the permitted services. The BVCA also objects to the proposed extension of these principles to non-PIEs.

The revised standards include no transition period and are expected to take effect for periods commencing on or after 15 December 2019.

OECD AIMING TO INTRODUCE NEW INTERNATIONAL TAXING RIGHTS THAT POTENTIALLY IMPACT THE ASSET MANAGEMENT INDUSTRY AT ASSET MANAGER, FUND AND PORTFOLIO COMPANY LEVELS

Throughout 2019 progress has been made on two OECD proposals arising from BEPS Action 1 (addressing the tax challenges arising from digitalisation) that will potentially fundamentally alter the landscape of international taxation. The OECD intends to agree a consensus solution by the end of 2020 and, although that is an ambitious timetable, it appears the political will may exist to meet it.

Importantly, the two proposals ("**Pillar One**" and "**Pillar Two**") would potentially impact on all multi-national enterprises ("**MNEs**") and not just the technology giants such as Facebook and Amazon. The proposed rules focus on the overall position of the MNE group rather than particular group entities.

Pillar One

Pillar One deals with the allocation of taxing rights between jurisdictions and, in October, the OECD published a consultation document seeking views on a proposal to create a new taxing right not based on having a physical location or permanent establishment in a jurisdiction. Broadly, under the proposal, the new taxing right would apply to large MNEs with "consumer" facing businesses that have a sustained and significant involvement in the economy of the relevant jurisdiction. Such involvement is likely to be defined by reference to a revenue threshold in the jurisdiction. Once it is determined that an MNE has the requisite involvement, the relevant jurisdiction will have a right to tax a share of its profit that remains above a deemed routine profit.

Pillar Two

This proposal, known as "GloBE" (Global Anti-Base Erosion), seeks to impose a minimum global tax rate for affected MNE groups. The OECD consider that such a rate reduces the incentives for tax payers to engage in profit shifting and establishes a floor for tax competition among jurisdictions.

In November the OECD published a consultation document in relation to GloBE. A key political issue here will be the agreement of the relevant minimum tax rate, however, the consultation document does not provide a figure, albeit some examples relating to technical mechanics contained in an annex to the document are based on a rate of 15%.

Impact on asset management

The proposals potentially impact the asset management industry at both fund and portfolio company levels, as well as asset management businesses themselves, so it is unsurprising that Invest Europe, the BVCA and other industry bodies have been active in responding to the consultations and liaising with the OECD.

At the fund level, a key concern is the interplay between the new taxing rights and the tax position of the fund vehicle itself (which typically will not be a tax-paying entity), in particular where the vehicle is not transparent for tax purposes. Clearly an additional layer of tax in the structure could seriously impact on a fund's viability and, accordingly, industry bodies have been emphasizing to the OECD the crucial role that collective investment plays in providing capital for business growth and the importance of respecting established national regimes that provide tax neutral fund structures. In relation to Pillar One, it is hoped that the OECD will accept that funds do not have "consumers" (rather, they have investors) and so should not be within the scope of the regime.

We expect that both Pillars will apply to MNEs owned by funds in the same way that they would apply to other MNEs, but industry bodies have taken care to alert the OECD to the importance of ensuring that separate portfolio businesses are not treated as part of the same MNE group for these purposes just because of their common ownership by the same fund (for example, to ensure that separate businesses that would individually be below any applicable threshold are not aggregated so as to be considered part of the same MNE group that meets the threshold).

For asset managers, in relation to Pillar One, it is (as with fund vehicles themselves) hoped that the OECD accept that they do not have "consumers", and so should not be within the scope of the regime. For Pillar Two, asset managers will be hoping that a size threshold is put in place sufficient to mean that most of them fall outside the scope of new minimum tax rate.

NEW TAX REPORTING REGIME FOR MANDATORY DISCLOSURE OF CROSS-BORDER ARRANGEMENTS (DAC 6) TO COME INTO FORCE

EU Directive 2018/822 ("**DAC 6**") introduces a new tax reporting regime in the UK from 1 July 2020. These rules will come into force regardless of the Brexit process. DAC6 applies to cross border arrangements which satisfy certain "hallmarks". Although the first disclosures are not required until this summer (2020), the rules will apply retrospectively to any arrangements put in place on or after 25 June 2018. The scope of the reportable arrangements under the relevant EU Directive is very wide and not limited to aggressive tax planning – in a number of circumstances, no tax advantage is even needed from the arrangement. If disclosure is required, a substantial amount of

information must be provided including the identities of all participants and advisers, and a summary of the arrangement, including explaining why it is caught.

NEW PAYROLL TAX OBLIGATIONS TO COME INTO FORCE FOR BUSINESSES WHICH ENGAGE CONSULTANTS THROUGH PERSONAL VEHICLES

In July, the Government published draft legislation implementing the expected imposition of new payroll tax obligations on businesses which engage consultants through personal vehicles. The rules will apply to payments made on or after 6 April 2020.

Under the new rules, the client will be responsible for deciding whether or not the rules apply by looking at whether the consultant would be considered to be one of its employees if you ignored the existence of the personal vehicle. If the consultant would be regarded as an employee, the person paying the personal vehicle's fee will generally be required to account for income tax and national insurance contributions (NICs), including employer NICs and the apprenticeship levy. Such payer will be the client, broadly, unless there is at least one intermediary between it and the personal vehicle. However, the rules will not apply to clients that are "small".

For detailed briefings please see:

- Off-Payroll Working Rules: The final proposals revealed – Does it apply to my business?
- Off-Payroll Working Rules: The final proposals revealed – What do you have to do under the New Rules?

FURTHER LEGISLATION ATTACKING TAX AVOIDANCE USING HYBRIDITY TO APPLY FROM 1 JANUARY 2020 IN EU MEMBER STATES

The EU's Anti-Tax Avoidance Directive ("ATAD I") was amended in May 2017. This amendment (ATAD II) extends the scope of the directive so that it applies to more hybrid structures. Member states are obliged to apply most of the measures from 1 January 2020 and both Luxembourg and Ireland have enacted implementing legislation. For our thoughts on the initial draft of the Luxembourg legislation please see our briefing: Asset management tax: what to know for the new autumn term.

Asset managers should be reviewing their fund and management structures in light of these new rules.

PRACTICAL ISSUES ARISING FOR REAL ESTATE FUND MANAGERS IN RELATION TO THE NON-RESIDENT PROPERTY GAIN RULES

Real estate fund managers are continuing to get to grips with the non-resident property gains rules (which came into effect on 6 April 2019), with an important deadline of 5 April 2020 approaching for those making elections and a close eye being kept on the forthcoming Budget in March to see if any withholding tax provisions will be introduced. For more on this regime, including a short recap of the rules, upcoming deadlines and issues that are being raised with us by fund managers and investors please click here.

NON-RESIDENT CORPORATE LANDLORDS TO BECOME LIABLE TO CORPORATION TAX (RATHER THAN INCOME TAX)

Non-resident corporate landlords are currently liable to income tax – not corporation tax – on net rental profits. However, from 6 April 2020, their rental profits will instead become subject to corporation tax, with different rates, computational rules and payment and filing requirements. For more information on this issue please click here.

LIMITED MARKET VALUE RULE TO BE INTRODUCED FOR STAMP DUTY AND SDRT FOR TRANSFERS OF UNLISTED SECURITIES BETWEEN CONNECTED PERSONS

In July 2019 the Government published draft legislation for the introduction of a limited market value rule for stamp duty and SDRT purposes on the transfer of unlisted securities. The rule applies to the transfer (or agreement to transfer) of unlisted securities to a company which is connected with the transferor. However, unlike the similar market value rule that was introduced in October 2018 for transfers of listed securities, the new rule will only apply where the consideration for the unlisted securities includes the issue of shares. Where the rule applies, the consideration is deemed, for stamp duty and SDRT purposes, to be equal to the higher of: (i) the amount or value of the consideration for the transfer; and (ii) the market value of the securities. The new rule is expected to have effect from the date that the Finance Act 2020 is passed.

In July HMRC also confirmed that, bearing in mind feedback received, they would not be taking forward any of the other proposals suggested in their consultation document (published in November 2018) relating to the consideration rules for stamp taxes on shares, for example, aligning the definitions of consideration for stamp duty and SDRT purposes.

A NEW REGIME RELATING TO CROSS-BORDER DISTRIBUTION OF FUNDS IS ON ITS WAY, INCLUDING A NEW EU-WIDE PRE-MARKETING DEFINITION

The Regulation on cross-border fund distribution ("**CBD Regulation**") and the Directive on the cross-border marketing of funds ("**CBD Directive**") entered into force on 1 August 2019. The majority of the CBD Regulation applies as from **2 August 2021** and EU Member States must also implement the CBD Directive as from that date.

Supervisors have had the ability to require the prior notification of AIF marketing communications to retail investors as from 1 August 2019 but, as at the time of writing, the FCA has not yet applied this and we are not currently aware of any other EU Member State doing so.

Application

The new regime will be directly applicable to EU alternative investment fund managers ("**AIFMs**") and managers of undertakings for collective investment in transferable securities ("**UCITS managers**"). It is increasingly likely, if not a near certainty, that the UK will no longer be a member of the EU in August 2021. It therefore remains to be seen to what extent UK fund managers will be affected, at least directly. To the extent that the regime amends the operation of the EU cross-border fund marketing passport regimes the UK may simply decide to revoke the directly-applicable Regulation (this would have been the effect of the Cross-Border Distribution of Funds, Proxy Advisors, Prospectus and Gibraltar (Amendment)(EU Exit) Regulations 2019 which would have come into force on 31 December 2019 had there been a "hard Brexit" then). It is possible, however, that even with such a revocation and no implementation of the Directive there may nonetheless be legislation 'onshoring' certain aspects of the regime into the UK. At the very least UK and other non-EU fund managers may find that they are affected by consequential amendments that individual EU Member States may decide to make to their national private placement regimes.

We discussed the CBD Regulation and the CBD Directive in more detail in our briefing in May 2019 (here).

'Pre-marketing' by AIFMs

The Alternative Investment Fund Managers Directive ("**AIFMD**") marketing passport only applies to activities that fall within the AIFMD's definition of 'marketing'. Individual member states have taken divergent views about when 'marketing' is deemed to begin. The CBD Directive attempts to address this by introducing a new definition of 'pre-marketing'.

In essence, 'pre-marketing' is defined as: information or communication relating to investment strategies or investment in order to test investor interest in a fund which is not yet established, or, is established but is not yet notified for marketing.

An AIFM will 'not be pre-marketing' where the information:

- is sufficient to allow investors to commit to the AIF;
- amounts to subscription documents in draft or final form; or
- amounts to final form constitutional or offering documents of a yet-to-be established AIF.

Cross-border distribution of funds

The AIFM will be required to send, within two weeks of the start of its pre-marketing, an 'informal letter' with details of the pre-marketing to its home member state regulator.

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Any third parties which the AIFM uses to pre-market on its behalf will essentially have to be licensed as MiFID investment firms or EU banks and will be subject to same conditions which apply to the AIFM itself.

Restricted reliance on reverse solicitation

Any subscription by investors in units or shares of an AIF that takes place within 18 months of the pre-marketing will be considered to be the result of marketing and the applicable marketing notification procedures under AIFMD will be triggered. This closes down any possibility of arguing that subsequent investments can be considered to result from reverse solicitation.

Marketing to retail investors

New requirements under AIFMD will apply when any AIFM (ie EU or non-EU) is marketing units or shares in an AIF to retail investors. The AIFM will be required to put in place certain 'facilities' in the relevant Member State to perform certain defined tasks.

Where an AIFM proposes to market to retail investors in a particular EU Member State, the regulator in that jurisdiction may require prior notification of the marketing communications which the AIFM intends to use. The relevant national regulator may request the AIFM to amend the marketing communication at any time within 10 working days of being notified.

The current AIFMD rules are unclear on when an AIFM can be considered to have ceased marketing in a Member State. A new provision in AIFMD will clarify that an AIFM may only discontinue the marketing of units or shares of an EU AIF in a jurisdiction in which it has exercised the marketing passport if the following conditions are met:

- The AIFM has publicised its intention to cease its marketing activities in respect of some or all of its funds in that jurisdiction through a publicly available medium, including by electronic means, which is customary for marketing AIFs and suitable for a typical AIF investor;
- Any contracts the AIFM has with financial intermediaries or delegates are modified or terminated with effect from the date of de-notification; and
- The AIFM has made a public offer to repurchase all the units or shares held by the investors in the relevant Member State—this condition does not apply to closed-ended AIFs or European Long-term Investment Funds (ELTIFs).

For 36 months after such de-notification, the AIFM will not be able to engage in any further pre-marketing of the relevant units or shares or of any 'similar investment strategies or investment ideas' in the relevant Member State.

Even after de-notification, the AIFM must nonetheless continue to provide investor transparency information (e.g. periodic reports) on an ongoing basis to investors.

What fund managers should be doing

Fund managers should monitor the extent to which aspects of the EU regime are 'onshored' into the UK on or following Brexit. They should also look out for any developments that individual EU Member States may make to their national private placement regimes in consequence of some of the changes introduced by the CBD Regulation and Directive.

NEW INCOMING LIQUIDITY STRESS TESTING GUIDELINES WILL APPLY TO AIFS AND UCITS

The European Securities and Markets Authority ("**ESMA**") has published its final guidelines on liquidity stress testing ("**Liquidity Guidelines**").

The Liquidity Guidelines will apply from **30 September 2020**. In terms of scope and application, they will:

- Apply fully in respect of UCITS and open-ended AIFs, including:
  - exchange-traded funds ("**ETFs**"), whether they operate as UCITS or AIFs; and
  - leveraged closed-ended AIFs,

  and will supplement the existing liquidity management requirements as set out in AIFMD and the UCITS Directive;
- Apply on a more limited basis to money market funds ("**MMFs**");
- Impose an obligation on depositaries to have appropriate verification procedures to check that fund managers have documented LST procedures in place.

Liquidity stress testing ("**LST**") is a risk management tool, within the overall liquidity risk management framework of a manager, which simulates a range of conditions, including normal and stressed conditions, to assess their potential impact on the funding, assets and overall liquidity of a fund and any necessary follow-up actions.

The Liquidity Guidelines include obligations to design and build LST models and to produce an LST policy. They also impose governance principles which require LST to be properly integrated and embedded into a fund's risk management framework and subject to appropriate governance and oversight. LST should employ historical scenarios, hypothetical scenarios and, where appropriate, reverse stress testing. Where appropriate, managers should aggregate LST across funds under management to better ascertain the liquidiation cost or time to liquidity of each security.

Under the Liquidity Guidelines, LST should occur at least annually but quarterly or more frequent LST is recommended.

HIGHER REGULATORY CAPITAL REQUIREMENTS, MORE ONEROUS REMUNERATION RULES, AND A RAFT OF OTHER GOVERNANCE, DISCLOSURE AND REPORTING REQUIREMENTS, WILL APPLY TO MOST MIFID INVESTMENT FIRMS (BY WAY OF THE INVESTMENT FIRMS REGULATION AND DIRECTIVE)

The new Regulation on prudential requirements for MiFID investment firms ("**IFR**") and the accompanying Directive ("**IFD**") came into force at the end of 2019 and will apply as of **26 June 2021**. We discussed the IFR/IFD in more detail in our briefing in May 2019 (here).

IFR/IFD introduce a bespoke prudential regime for most MiFID investment firms to replace the one that currently applies under the fourth Capital Requirements Directive and the Capital Requirements Regulation ("**CRD IV**").

IFR/IFD will mean higher regulatory capital requirements for firms, subject to some transitional phasing-in in respect of own funds. IFR/IFD will also

mean new, more onerous remuneration rules based on those applicable to banks, as well as a raft of internal governance and disclosure and reporting requirements.

Scope and Application

IFR/IFD applies to MiFID investment firms other than those larger firms which deal on own account and/or carry out the activities of underwriting or placing on a firm commitment basis and which by virtue of their size and/or interconnectedness in the financial system are considered to be of systemic importance. Those large firms will be subject to CRD IV instead.

The majority of MiFID investment firms, including portfolio managers and, in all likelihood, many advisers/arrangers, will therefore be subject to IFR/IFD.

Where a MiFID investment firm meets the requirements to be a "small and non-interconnected investment firm", IFR/IFD applies, but on a limited basis. In particular, the remuneration requirements will not apply to such firms and they will not be required to make use of the K-factors metric when calculating own funds.

For the most part, IFR/IFD does not affect collective investment fund managers directly. However:

- Depending on future UK government policy, AIFMs with MiFID top-up permissions will - consistent with the approach the UK has previously adopoted in respect of prudential matters - be caught;
- As summarised below, despite generally not applying to AIFMs directly, the new legislation will nonetheless make a specific amendment to AIFMD in terms of own funds; and
- IFR/IFD will clearly be relevant to fund management groups which have MiFID firms within their structures.

As with the EU cross-border distribution of funds package, the IFR/IFD regime will likely apply some time after the UK has left the EU. To a considerable extent, IFR/IFD reflects policy developed in the UK and, for the time being at least, the assumption is that the UK authorities will wish to impose similar domestic legislation. Whether there may be divergences in the detail (for instance, with regards to the imposition of remuneration requirements) depends on the UK's policy on the interrelationship between UK and EU regulation and the degree of 'equivalence' that will be sought. Firms should therefore look out for details of how H.M. Treasury and the FCA intend to 'onshore' the regime in the UK.

Prudential groups and consolidation

All investment firms subject to IFR/IFD must comply with the regime's requirements relating to own funds composition, the calculation of capital requirements, concentration risk, liquidity requirements, disclosure and reporting on a solo (individual firm) basis.

In general, a parent investment firm, parent investment holding company or parent mixed financial holding company in the EU (whether or not regulated) shall also be required to apply all of the above requirements on a consolidated (or group) basis. For most firms, this does not represent a change to existing group requirements, but it will be new for some, e.g. advisers/arrangers.

By way of derogation to the full prudential consolidation requirement described above, supervisors will have the discretion to apply a simpler and lighter-touch group capital test in the case of group structures which they deem to be "sufficiently simple" and in respect of which no significant risks to clients or to the market will arise from not applying consolidated supervision.

If full prudential consolidation under the IFR applies, then the IFD's requirements relating to internal governance, transparency, treatment of risks and remuneration will also be applied to firms which are subject to the full application of the regime on a solo and consolidated basis (except in relation to certain third-country subsidiaries where it would be unlawful to do this).

Remuneration

The remuneration requirements apply in respect of staff, such as senior management and employees with comparable remuneration, whose professional activities have a material impact on the risk profile of the firm or the assets that it manages.

The requirements relating to remuneration include:

- A requirement to have a remuneration policy that is proportionate to the size, internal organisation and nature of the firm and the scope and complexity of its activities and which complies with a number of principles.
- A requirement to set - and publish - appropriate ratios of variable remuneration to fixed remuneration that may be paid to relevant staff, ensuring that the fixed component represents a "sufficiently high proportion" of the total remuneration to enable the operation of a fully flexible policy on variable remuneration components.
- A requirement for any variable remuneration to comply with a number of requirements, including as to allocation and deferral as well as malus (i.e. restrictions on vesting) and clawback.
- A requirement to establish an independent and gender balanced remuneration committee.

- A requirement to make certain disclosures regarding the remuneration policy and practices as well as providing remuneration information to supervisors.

As stated above, none of the remuneration requirements apply to SNIFs. In addition, other firms which are below certain certain size criteria will not have to comply with the requirements governing the constitution of variable pay and the deferral of payment or the need to have a remuneration committee.

Quantitative capital requirements

Subject to transitional phasing-in, a firm will generally be required to have own funds at all times at least equal to the highest of its:

- *fixed overheads requirement* – at least one quarter of its fixed overheads for the preceding year;
- *permanent minimum requirement* – for a portfolio manager or adviser/arranger (which does not hold client money) it is likely to be EUR 75,000 and, for a firm with a principal dealing permission, EUR 750,000; and
- *"K-factor" requirement* – a new, activities-based capital requirement based on an aggregation of three risk factors applicable to the firm (each of which has a number of highly detailed components).

In addition to the own funds requirements, firms will be required to hold an amount of liquid assets equal to at least one third of their fixed overheads requirement, which, in practice, will equate to one month's fixed overheads.

Supervisors can also require firms to hold additional capital in certain circumstances such as where they consider that the firm is exposed to risks which are not adequately covered by the standard capital requirements.

Disclosures and public reporting

Firms will also be subject to a wide range of disclosure and reporting requirements under IFR/IFD. These include (but are not limited to) the requirement to make public disclosures about their capital, capital requirements, risk management objectives and policies, internal governance arrangements and remuneration policies and practices.

Public country-by-country reporting rules will also apply as well as a requirement to report certain regulatory capital information to supervisors and for larger firms to disclose certain voting information.

Third country firms and equivalence assessments

IFR/IFD amends the rules on assessing third countries for equivalence in relation to the provision of cross-border services by third country firms under MiFIR to state that when carrying out any equivalence assessment in relation to a third country for those purposes, the Commission must take into account (amongst other factors):

- Whether firms in that jurisdiction are subject to prudential, organisational and business conduct requirements which are equivalent to those which apply in MiFIR, CRD IV and IFR/IFD; and
- Whether firms in that third country are subject to effective supervision and enforcement to ensure compliance with those requirements.

Application to AIFM and UCITS

While the new regime does not directly impact upon collective investment fund managers, IFD does nonetheless make specific amendments to both AIFMD and the UCITS Directive to provide that own funds of an alternative investment fund manager or UCITS management company can never be less than the fixed overheads requirement as specified in IFR – i.e. at least one quarter of the fixed overheads of the preceding year.

Conclusion

The rules are likely to be a significant step up for many investment firms, but the biggest impact is likely to be for adviser/arranger firms which will likely face a significant increase in their capital requirements and be subject to new rules on prudential consolidation and detailed remuneration for the first time.

The new regime will also introduce a stricter framework for third-country firms seeking to rely on the equivalence provisions in the Markets in Financial Instruments Regulation (**MiFIR**).

Firms should monitor implementation of the regime in the UK.

IMPORTANT CHANGES TO MONEY LAUNDERING OBLIGATIONS IN FORCE FROM 10 JANUARY 2020

The fifth Money Laundering Directive ("**MLD 5**") had to have been transposed by EU Member States by 10 January 2020. It will be implemented in the UK by way of changes to the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the "**MLRs"**). H.M. Treasury consulted on policy issues regarding the transposition back in April 2019 and it was clear then that it was looking not only at transposition of MLD 5 but also to give effect to some FATF Recommendations. The Money Laundering and Terrorist Financing (Amendment) Regulations 2019 were finally made on 19 December 2019 and laid before Parliament on 20 December 2019. For the most part they come into force on **10 January 2020**.

The main changes reflected in the amendments to the MLRs are as follows:

- There are stricter requirements when carrying out customer due diligence; including requirements to obtain and verify additional information when carrying out customer due diligence on a body corporate and to understand the business, ownership and control structure of their customers, however constituted;
- There are a new set of prescribed enhanced due diligence measures that firms will be required to carry out in relation to new business relationships or transactions involving high risk third countries (i.e. countries which have been identified by the European Commission as high risk third countries in a delegated act adopted under Article 9(2) MLD 4) – these include obtaining additional information on the customer and its beneficial owner, the intended nature of the business relationship and obtaining the approval of senior management for establishing or continuing the business relationship;
- Where the customer appears on a beneficial ownership register (e.g. the UK PSC Register) relevant firms are required to collect *proof of such registration* or an *excerpt of the* register and to report to a relevant person (e.g. the registrar of companies) any discrepancies they discover between the information they hold and the information that appears on the register;
- Where the firm is part of a group it is already required to establish and maintain policies, controls and policies throughout the group for data protection and the sharing of information; however, the amended MLRs require firms to have to have policies requiring customer, account and transaction information to be provided to them from their branches and subsidiaries; and
- There is clarification of the circumstances in which firms will be required to refresh customer due diligence on existing customers – broadly this will be when the firm has any legal duty to contact the customer for the purpose of reviewing any information which is relevant to the firm's assessment for that customer and which relates to the beneficial ownership of the customer and/or when the firm is required to contact the customer in order to fulfil any duty under the International Tax Compliance Regulations 2015.

We discussed the changes in more detail in the following briefings: MLD 5: the MLD 4 upgrade and MLD 5: HMT consultation on UK transposition.

The amended MLRs do not contain changes to take account of the MLD 5 requirement that all express trusts should be registered, regardless of whether they generate tax consequences. However, the government will be publishing a more detailed technical consultation early in 2020 which will include draft legislation dealing with the trust registration requirements of MLD 5.

On its webpage, the FCA has said "We expect firms to comply with the new, amended regulations from 10 January 2020".

On 23 December 2019, the FCA published a webpage highlighting some specific new areas that firms will need to comply with under the amended MLRs. Given that the amending statutory instrument was published only three weeks before the date on which the changes to the MLRs come into force, the FCA expressed a limited degree of regulatory forbearance:

"*We expect firms to comply with the new, amended regulations from 10 January 2020. In assessing our approach to firms that may not be compliant on that date, we will take into account evidence that they have taken sufficient steps before that date to comply with these new obligations.*"

In the light of the FCA's comments, firms should prioritise the finalisation of updates to their policies and procedures to ensure they are compliant.

EU WIDE SECURITIES FINANCING TRANSACTIONS' REPORTING OBLIGATIONS WILL SOON INCLUDE AIFS AND UCITS

The EU Securities Financing Transactions Regulation ("**SFTR**") has applied from 12 January 2016, although certain of its requirements entered into force on a phased basis. The final set of substantive obligations under the SFTR that have not yet entered into force are those which relate to the requirement for counterparties to SFTs to report details of those transactions to a trade repository. Legislation has finally been published meaning that such reporting obligations will commence on a staggered basis over the next year depending on the type of institution. The commencement dates are as follows:

- 11 April 2020 – credit institutions (such as banks) and investment firms;
- 11 July 2020 – central securities depositaries (CSDs) and central counterparties (CCPs);
- **11 October 2020 – all other financial counterparties (FCs) starts – this includes AIFs and UCITS;**
- 11 January 2021 – non-financial counterparties (NFCs)(such as listed and unlisted corporates).

This means that affected firms will have to use the next few months to finalise their preparations so that they are ready to report their SFTs by the relevant start date: this will include having to establish internal procedures and relevant external legal arrangements (regarding, amongst other things, the collection of data and its onward transmission to a trade repository (or to a third party service provider who will report on their behalf)).

Points to note with regards to the reporting obligation include:

- In terms of territorial scope, the reporting requirement will apply:
    - to the principal counterparty to the transaction where it is established in the EEA; and
    - to an EEA branch of a non-EEA entity where the transaction is concluded through the branch (noting however that a non-EEA AIF would never in practice be operating out of an EEA branch and cannot therefore be within the scope of the SFTR reporting obligation);
    - according to ESMA, to a non-EEA AIF with an AIFM registered or authorised under AIFMD (i.e. regardless of the fact that the AIF is established outside the EEA). However, this was a passing comment from ESMA in its Final Report which accompanied its *Guidelines on reporting under Articles 4 and 12 SFTR* published on 6 January 2020; but this comment was not reflected in the Guidelines themselves nor does it appear to be consistent with the provisions of SFTR itself);
- A reporting counterparty may appoint a third-party service provider as its delegate to report on its behalf (although the reporting counterparty will remain responsible and legally liable);
- Reportable SFTs will include repos, securities and commodities lending transactions/securities and commodities borrowing transactions, buy sell backs and sell-buy backs and margin lending transactions.

THE TRANSITION TO A REPLACEMENT RATE FOLLOWING THE DISCONTINUATION OF LIBOR

The London Interbank Offered Rate ("**Libor**") is expected to be discontinued by the end of 2021 and there has been increased pressure from the regulators (including the Financial Conduct Authority) to ensure that market participants cease to use this benchmark well in advance of the "big bang" date. Most funds are likely to be affected by the Libor discontinuation – funds might use Libor as benchmark or performance targets, and its administrators, managers and custodians as an input to their valuations and risk assessments. Also, Libor might feature across a fund's investments, as it is commonly referenced in funding arrangements, interest rate derivatives transactions, as well floating rate notes and securitisations. It is important for funds to work closely with their managers, custodians and counterparties to assess their exposure to Libor and determine the steps they will need to take to ensure that the transition to the replacement rate is implemented as smoothly as possible.

The Bank of England's Working Group on Sterling Risk-Free Reference Rates (the "**RFR Working Group**") has recommended Sterling Overnight Index Average ("**SONIA**") as its preferred replacement rate for Libor in sterling markets – and it is currently working together with key industry bodies, including the Loan Market Association and International Swaps and Derivatives Association, to establish the parameters and adjustments that should be used by market participants when transitioning their existing contracts to the replacement rate. The RFR Working Group has also been working on the development of a forward looking term SONIA.

Implications for Funds

Funds should:

(i) monitor liquidity in Libor-indexed contracts to assess the timing for transition in relation to each asset class – it is expected that liquidity will start to wane ahead of 2021;

(ii) work on amendments to their existing contracts to deal with Libor fallback mechanics; and

(iii) assess any regulatory, accounting and tax implications resulting from amending (or opting not to amend) their contracts (e.g. loss of regulatory grandfathering, significant accounting or tax gains or losses).

The industry's work on Libor discontinuation is part of a broader benchmark reform which under the EU Benchmarks Regulation requires certain 'supervised entities' to ensure that they have robust written plans setting out the actions that they would take if a benchmark materially changes or ceases to be provided, and to reflect these plans in their contractual arrangements. Funds should also consider if and how this regulation might apply to their arrangements.

PRIIPS REGIME: PROPOSED AMENDMENTS TO OBLIGATIONS RELATING TO PERFORMANCE SCENARIOS, PAST PERFORMANCE INFORMATION, COSTS CALCULATION METHODOLOGIES AND MULTI-OPTION PRODUCTS

In October 2019, the Joint Committee of the European Supervisory Authorities ("**ESAs**") published a

consultation paper on proposed amendments to the PRIIPs Commission Delegated Regulation ((EU) 2017/653) (the "**PRIIPs Delegated Regulation**"). The PRIIPs Delegated Regulation seeks to address the main regulatory issues that have been identified since the implementation of the PRIIPs KID.

The proposed amendments to the existing regulatory technical standards ("**RTS**") relate to:

- proposals to change the methodology for performance scenarios;
- possible alternative to present illustrative performance scenarios
- how past performance information could be included in the KID
- different options to change the methodologies to calculate costs and how these are presented in summary tables;
- possible changes in view of the exemption in Article 32 of the PRIIPs Regulation being due to expire and the possible use of the PRIIPs KID by UCITS from 1 January 2022
- specific issues for PRIIPs offering a range of options for investments (so-called "multi-option products"). The consultation paper includes an example KID for such products.

This Consultation Paper follows a previous ESA consultation on the PRIIPs KID in November 2018 (CP 2018 60). The November 2018 consultation paper proposed more targeted amendments to the PRIIPs Delegated Regulation. Based on the feedback received to that consultation, the ESAs decided in February 2019 to defer their review and launch a public consultation on more substantive changes later in 2019. The ESAs now intend to conclude their review around the end of the first quarter 2020 and submit their final proposals to the European Commission shortly afterwards.

The deadline for consultation responses was 13 January 2020.

ELTIF REGIME: PROPOSED AMENDMENTS TO THE DISCLOSURE OF COSTS COULD REQUIRE INCLUSION OF CARRIED INTEREST IN THE PRESENTATION OF COSTS

In March 2019, ESMA published a consultation in relation to draft regulatory technical standards ("**RTS**") to determine the costs disclosure requirements applicable to ELTIF managers under the ELTIF Regulation. In doing so, ESMA has considered the corresponding regulatory technical standards under the PRIIPs Regulation.

In its response to the consultation, Invest Europe highlighted its concerns that the provisions led to unintended (and adverse) consequences for ELTIFs marketed by private equity fund managers, creating confusion for investors. While carried interest is not listed specifically in the ELTIF Regulation, the draft RTS make it clear that it would have to be included within the presentation of costs. Moreover, unlike in the PRIIPS Delegated Regulation, carried interest is not treated separately from performance-related fees in the draft RTS and carried interest may have to be presented as a yearly cost and as a percentage of the capital. Invest Europe state that this proposed approach would not be representative of the real impact of carried interest on investors' returns.

In December 2019, ESMA published its final report detailing feedback received in relation to the consultation. ESMA also announced the postponement of the RTS being published and coming into force. The RTS will depend to a large extent on the costs section of the PRIIPs KID, which itself is currently subject to proposed amendments. ESMA has therefore decided to postpone finalising the draft RTS until the outcome of the review of the PRIIPs regime.

FOR FURTHER INFORMATION, PLEASE CONTACT

Aaron Stocks
Head of Funds

aaron.stocks@traverssmith.com
+44 (0)20 7295 3319

Sam Kay
Partner, Funds

sam.kay@traverssmith.com
+44 (0)20 7295 3334

Will Normand
Partner, Funds

will.normand@traverssmith.com
+44 (0)20 7295 3316

Jeremy Elmore
Partner, Funds

jeremy.elmore@traverssmith.com
+44 (0)20 7295 3453

Emily Clark
Partner, Head of Tax

emily.clark@traverssmith.com
+44 (0)20 7295 3393

Elena Rowlands
Partner, Funds Tax

elena.rowlands@traverssmith.com
+44 (0)20 7295 3491

Cathryn Vanderspar
Consultant, Funds Tax

cathryn.vanderspar@traverssmith.com
+44 (0)20 7295 3337

Tim Lewis
Head of Financial Services & Markets

tim.lewis@traverssmith.com
+44 (0)20 7295 3321

Stephanie Biggs
Partner, Financial Services & Markets

stephanie.biggs@traverssmith.com
+44 (0) 20 7295 3433

Phil Bartram
Partner, Financial Services & Markets

phil.bartram@traverssmith.com
+44 (0)20 7295 3437

Michael Raymond
Partner, Financial Services & Markets

michael.raymond @traverssmith.com
+44 (0) 20 7295 3487

Charles Bischoff
Partner, Funds Finance

charles.bischoff@traverssmith.com
+44 (0)20 7295 3378

Danny Peel
Partner, Funds Finance

daniel.peel@traverssmith.com
+44 (0)20 7295 3441

Jonathon Gilmour
Partner, Head of Derivatives & Structured Products

jonathon.gilmour@traverssmith.com
+44 (0)20 7295 3425

Manisha Shukla
Knowledge Counsel, Funds

manisha.shukla@traverssmith.com
+44 (0)20 7295 3218