# Funds Bulletin

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Hogan Lovells

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# 1. Brexit

## 1.1 Brexit: European Union (Notification of Withdrawal) Bill introduced

The European Union (Notification of Withdrawal) Bill was introduced to the House of Commons and given its First Reading. A related set of explanatory notes has also been published.

The Bill would give the Prime Minister power to notify the European Council of the UK's intention to withdraw from the EU. The Bill had its Second Reading and has concluded its stages in the Commons and has now been passed to the House of Lords. The Government intends that the Bill will receive Royal Assent and be enacted prior to 31 March 2017.

## 1.2 Brexit: UK financial services regulation - FSCP position paper

The Financial Services Consumer Panel (FSCP) published a position paper and related research on the implications of Brexit for financial services consumers. The research looks at those areas where consumers could benefit from the withdrawal as well as those protections which exist at the moment and might be lost.

Among other things, the position paper looks at risks to consumers as a result of Brexit, sets out good consumer outcomes post-Brexit and sets out a number of recommendations to the regulator and Government, including:

- consumers should remain at the heart of negotiations on Brexit: the Brexit Select Committee should ensure it focuses on making the best of Brexit for individual consumers as well as businesses;
- aligning the UK's competitiveness objectives with good consumer outcomes: the Government should resist de-regulatory pressures to make the industry competitive in the short term at the expense of consumers;
- effective regulation and the Financial Conduct Authority's (FCA) mission: as the FCA seeks to shape its mission and clarify interpretations of consumer responsibility and the boundaries between public policy and supervision, the drive towards effective regulation should take into account future regulatory developments at EU level. This means ensuring that the FCA adheres to EU level legislation when consumer protections are stronger and cross-border regulation is more effective than having a purely national approach;
- the transition to the new post-Brexit regulatory regime: the FSCP says that it is understandable that the exact details of the transitional arrangements may only become clear late in the day. However, given the issues with regards to supply of services and the impact on competition it is important that the major details of the transition are spelled out as soon as is practically possible. The length of the transition, for instance, is of particular significance;
- define a long-term vision and role for the UK: over the last 40 years, the UK has been at the heart of financial services legislation in the EU. The FSCP says that the UK has acquired, within EU circles, the status of thought leader at all levels showcasing best practice in important areas of legislation in different sectors. The UK should continue to play this role to the extent possible especially in areas where consumer protections are stronger at UK level and could be strengthened at EU level; see further our Brexit hub.

# 2. Global and EU Developments

## 2.1 IOSCO's findings on loan funds – no further work at this stage

The International Organisation of Securities Commissions (IOSCO) published a report on the findings of its survey on loan originating funds and loan participating funds (together "Loan Funds"). The report covers both open ended and closed ended funds and both retail and non-retail funds (but not securitisation special purpose vehicles).

The report sets out the current approach and national regimes for Loan Funds in various jurisdictions (noting that currently the UK and Luxembourg are the main European domiciles for loan funds and that certain jurisdictions have specific regulatory frameworks for Loan Funds). Particular risks associated with Loan Funds are also highlighted, including:

- liquidity risk;
- credit risk;
- systemic risks from excessive credit growth; and
- regulatory arbitrage.

It concludes that further work on Loan Funds is **not** warranted at this stage, but in light of the risks involved, it will continue to monitor these types of funds with a view to possibly reviewing these further. A related development from last year is ESMA's opinion on a potential EU regulatory regime for loan originating funds, which we covered in our April Funds Bulletin).

## 2.2 UCITS share classes: ESMA opinion

The European Securities and Markets Authority (ESMA) published an opinion on the extent to which different types of units or shares (share classes) of the same UCITS fund can differ from one another, having found diverging approaches in different EU countries.

UCITS can be sold to retail investors throughout the EU. However, there is currently no common EU framework for share classes, with some countries prohibiting the set-up of different share classes within a single fund and others permitting it with varying degrees of flexibility. While all investors in a UCITS fund invest in a common pool of assets, share classes attribute different rights or features to sub-sets of investors although there is no legal segregation of assets between the share classes.

In the opinion, which is addressed to national regulators, ESMA sets out four high-level principles which UCITS must follow when setting up different share classes in order to ensure a harmonised approach across the EU:

- **common investment objective**: share classes of the same fund should have a common investment objective reflected by a common pool of assets. ESMA considers that hedging arrangements at share class level, with the exception of currency risk hedging, are not compatible with the requirement for a fund to have a common investment objective;
- **non-contagion**: UCITS management companies should implement appropriate procedures to minimise the risk that features specific to one share class could have a potentially adverse impact on other share classes of the same fund;
- **pre-determination**: all features of the share class should be pre-determined before the fund is set up; and
- **transparency**: differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes.

ESMA says that it is aware that these principles will have an impact on investment fund markets in countries where share classes can currently be set up which do not comply with them. Therefore, to mitigate the impact on investors in share classes established prior to this opinion which do not comply with these principles, ESMA is of the view that they should be allowed to continue. However, such share classes should be closed for investment by new investors within six months of publication of the opinion,

and for additional investment by existing investors within 18 months of publication.

## 2.3 EMIR variation margin deadline 1 March: ESAs recommends risk-based enforcement

From 1 March 2017, variation margin requirements under RTS under the Regulation on over-the-counter derivatives, central counterparties and trade repositories (known as the European Markets Infrastructure Regulation (EMIR)) will apply to non-cleared OTC derivatives trades. These requirements are onerous as only cash (and certain highly liquid assets) can be used as margin. Many market participants are therefore anticipated to be unable to meet this compliance deadline. In light of this, regulators in the U.S. and the EU and IOSCO have recently given some similar guidance on their approach to enforcement, which should give some limited comfort to market participants; see further our briefing.

The Joint Committee of the three European Supervisory Authorities (ESAs) (that is, the European Banking Authority, the European Insurance and Occupational Pensions Authority and ESMA) don't have power to formally delay the compliance deadline, but have encouraged national competent authorities to adopt a risk-based approach to the enforcement of the rules (see the ESA's statement). They should take into account the size of exposure to the counterparty and its default risk. In the absence of meeting the March 1, 2017 deadline, market participants should document the steps taken towards full compliance and put in place alternative arrangements to ensure that the risk of non-compliance is contained. The FCA welcomed the ESA's enforcement approach (see FCA's statement).

### *Background*

Funds often use derivatives, usually in the form of interest rate swaps, to hedge their cost of debt finance. The fund would then pay the swap (fixed) rate instead of the floating rate on its debt. Traditionally, the debt and the swap would be secured against for example a real estate fund's property portfolio. However, EMIR requires funds to use cash as collateral (or certain other highly liquid assets such as allocated gold, debt securities issued by government entities, corporate bonds, convertible bonds and equities) to cover their derivative positions. This will require funds to deposit significant amounts of cash (or highly liquid assets) in margin accounts with central clearing houses.

## 2.4 EMIR: ESMA updates Q&As on implementation of EMIR

ESMA published an updated version of its questions and answers (Q&As) on implementation of EMIR.

The updated Q&As include a new Q&A (see question 44 in the section on trade repository (TR) questions) in relation to transition to the revised technical standards on reporting, which will become applicable on 1 November 2017. The Q&A clarifies that the reporting entities are not obliged to update all the outstanding trades upon the application date of the revised technical standards and that they are required to submit the reports related to the old outstanding trades only when a reportable event takes place (for example, when the trade is modified). Furthermore, the Q&A explains how those reports will be validated by TRs.

## 2.5 PRIIPs with environmental or social objectives: Joint Committee of the ESAs consultation

The Joint Committee of the three European Supervisory Authorities (ESAs) (that is, the European Banking Authority, the European Insurance and Occupational Pensions Authority and ESMA) published a consultation paper on a proposal to set minimum requirements, which manufacturers of packaged retail and insurance-based investment products (PRIIPs) with environmental or social objectives (EOS

PRIIPs) should comply with to ensure that credible products are offered to retail investors.

The manufacturer of an EOS PRIIP is required to have specific governance measures in place to ensure that environmental or social objectives are met on an on-going basis and must be able to demonstrate the relevance of these objectives to retail investors throughout the investment process.

The consultation paper provides an analysis of the current legal framework for product oversight and governance rules and considers whether there are possible gaps regarding EOS PRIIPs. Existing product oversight and governance provisions, laid down in the relevant legislation for PRIIPs, including in the MiFID II Directive and the Insurance Distribution Directive, are in general found to be sufficient for PRIIPs. However, for EOS PRIIPs, the ESAs consider that it is important for the Commission to provide additional guidance to the respective manufacturers when interpreting the existing rules.

Comments are requested by 23 March 2017. The Joint Committee will submit the technical advice to the Commission by 30 April 2017. The ESAs also intend to publish final feedback on the consultation at the same time.

## 2.6 Transparency Directive - Major holdings notifications guide

ESMA has published a practical guide that gives an overview of the national requirements relating to notifications of major holdings under the Transparency Directive. The guide covers various aspects of the national regimes, including:

- the competent authority;
- the notification thresholds;
- the requirements in relation to the notification process;
- the triggering event for on-exchange transactions;
- the permitted channels and formats for the filing of a notification; and
- standard form, if any, for the notification of major holdings.

## 2.7 MAR: ESMA updates Q&As

ESMA published an updated version of its document containing questions and answers (Q&As) in relation to the implementation of the Market Abuse Regulation (MAR) to include new Q&As on:

- the notification of managers' transactions (see section 2, question 6); and
- how to handle investment recommendations (see section 3, questions 9, 10 and 11); see further our briefing.

## 2.8 Capital markets union action plan: European Commission consultation

The European Commission published a consultation paper on the planned capital markets union (CMU) mid-term review. A set of frequently asked questions has also been published.

The consultation paper looks at the state of play of implementation of the action plan with regard to the following topics and also looks at the associated key trends and challenges:

- financing for innovation, start-ups and non-listed companies;
- making it easier for companies and enter and raise capital on public markets;
- investing for long term infrastructure and sustainable investment;
- fostering retail investment and innovation;
- strengthening banking capacity to support the wider economy;
- facilitating cross-border investment.

Comments are requested by 17 March 2017. The Commission will evaluate the responses and produce a summary feedback statement. It will also hold more focused roundtable discussions on small and medium enterprise access to

finance, retail investor engagement and institutional investment.

# 3. UK Developments

## 3.1 FCA discussion paper on illiquid assets and open-ended investment funds

The FCA published a discussion paper (DP17/1) considering some of the risks that arise when open-ended investment funds are used for illiquid assets such as real estate, infrastructure, and unlisted securities. Typically, closed ended fund structures are used for illiquid assets.

In an accompanying *press release*, the FCA explains that one of the key issues DP17/1 raises is balancing the interests of investors who want to withdraw their money (ie redeem their interest) and those who want to remain in the fund. Difficulties can arise if investors expect to be able to withdraw their money at short notice since, for example, many funds offer investors daily dealing opportunities, but hold assets that are not re-valued on a daily basis. This creates a tension, as assets cannot be sold in a day to meet daily redemption requests. The FCA notes that these difficulties can be exacerbated if an event in the market triggers an upsurge in redemption demand, or market conditions change for the underlying assets. This happened after the Brexit referendum vote in June 2016, when liquidity management issues arose in some UK open-ended property funds.

In the three main chapters of DP17/1, the FCA:

- describes the liquidity management issues that some UK property funds experienced in 2016 and explains how it responded to them;
- describes how current regulations apply to funds investing in illiquid assets and offer their managers a variety of liquidity management tools;
- suggests some possible approaches to developing the regulation of liquidity, to support fund managers in meeting their obligations and ensure good outcomes for investors.

The FCA requests comments on DP17/1 by 8 May 2017.

## 3.2 Review of the effectiveness of primary markets: enhancements to the listing regime and the UK primary markets landscape

The FCA published a consultation paper, CP17/4, and a discussion paper DP17/2 as part of its 2016/2017 Business Plan commitment to review the structure of the UK's primary markets to ensure they continue to serve the needs of issuers and investors.

### *Consultation paper (CP 17/4)*

The consultation paper (CP17/4) contains proposals on certain technical amendments to the Listing Rules (LR), which include:

- the treatment of transactions that are outside the ordinary course of business and which are, or are proposed to be, undertaken by listed issuers. These changes involve the so-called "class tests", used to assess the size of the transaction relative to the listed issuer, and specifically the "profits test";
- the FCA's approach to suspending the listing of an issuer that has announced a reverse takeover, or where details of such a transaction have leaked.

### *Discussion paper (DP17/2)*

In its discussion paper, the FCA is seeking feedback on how the UK primary capital markets can most effectively meet the needs of issuers and investors.

In particular, the FCA is interested in views on:

- whether the current boundary between the standard and premium listing categories is appropriate, particularly in relation to overseas issuers and exchange traded funds (ETFs), and looking more broadly at the role that standard listing plays in practice;
- the effectiveness of UK primary equity markets in providing capital for growth, particularly for early stage science and technology companies;

- whether there is a role for a UK primary debt multilateral trading facility, and its potential structure; and
- measures that could be introduced to support greater retail participation in debt markets.

***Discussion paper on information in the IPO process***

The FCA will also consult shortly on how to improve the information available in the UK initial public offering process, following its April 2016 discussion paper on this issue as covered in our May Funds Bulletin.

***Next steps***

Comments on both CP 17/4 and DP17/2 are requested by 14 May 2017. The FCA says that it will publish its rules in a policy statement in the second half of 2017 and a feedback statement. Should it choose to advance any specific policy proposals as a result of the feedback to the discussion paper, it will publish a further consultation paper.

## 3.3 Extension of the senior managers and certification regime to all FSMA authorised firms: FCA date for consultation

The Bank of England and Financial Services Act 2016 includes the extension of the senior managers and certification regime (SM&CR) to all Financial Services and Markets Act 2000 authorised firms. This will affect firms who offer financial services and are regulated by the Financial Conduct Authority (FCA).

The FCA has updated its webpage on the SM&CR to give the information that it is developing its approach to the extension of the SM&CR and its current plan is to consult during the second quarter of 2017. HM Treasury has stated its intention that the regime should start from 2018.

# 4. EU and Global Tax Developments

## 4.1 FTT Discussions Delayed

Reports suggest further delays to discussions to introduce a financial transactions tax across part of the EU. It has been reported that talks due to be held on 26 January, which were expected to discuss responses to Belgian and Slovakian concerns, were delayed because of ministerial availability Talks were instead scheduled for late February. Pierre Moscovici, the European Commissioner for Taxation, remained positive about the project, recognising that further work is needed: "*A deal is within reach, if we only consider the technical and legal issues. But what is needed is political will.*"

Reports have since suggested that the talks held in February were inconclusive, and that the treatment of pension funds (a particular concern of Belgium) remains a significant barrier to agreement. Further delays to the tax are likely as further analysis is undertaken, with the next meeting scheduled for late March.

# 5. UK Tax Developments

## 5.1 Interest Deductibility Restrictions for Collective Investment Vehicles

Draft regulations have been published by HMRC to amend the tax treatment of collective investment vehicles and securitisation vehicles in light of the new interest deductibility rules as announced in the Draft Finance Bill 2017. The draft regulations are designed to avoid unintended consequences of the new regime. In particular, they provide that interest distributions by various authorised funds including AIFs and tax elected funds are not tax-interest expense amounts, and therefore will be outside the scope of the new regime. Various other provisions are also aimed at securitisation and insurance securitisation companies. The draft regulations are intended to have effect for accounting periods beginning on or after 1 April 2017 (with straddling accounting periods split) and comments on them are invited by 18 April 2017.

## 5.2 HMRC Announces Finance Bill Publication Date

HMRC has announced that the Finance Bill 2017 will be published on 20 March 2017, following the Budget 2017 on 8 March 2017.

# 6. US Tax Developments

## 6.1 "Two for one" executive order postponing US tax guidance

President Trump issued an executive order on January 30 requiring agencies including the U.S. Treasury Department and the Internal Revenue Service to eliminate two regulations for every new one to be issued. Previously, the White house had issued a memo freezing all new and proposed regulations that caused the IRS to withdraw the new partnership audit regulations (see our prior coverage in our January Funds Bulletin). It remains uncertain what these executive actions mean for the partnership audit regulations as well as other regulations and guidance scheduled to be issued.

Treasury Deputy Tax Legislative Counsel Krishna Vallabhaneni said "*it's not entirely clear that anything will be coming out imminently or in the near future*." Many speculate the new executive order could prolong the timeline by which the IRS and Treasury Department issue regulations. Vallabhaneni indicated taxpayers should not expect revenue rulings, revenue procedures, or any other type of substantive guidance for a while. However, taxpayers can still apply for taxpayer-specific guidance, such as private letter rulings.

## 6.2 Tax overhaul

On February 9, President Trump promised a "phenomenal" tax plan on the horizon. White House press secretary promised it will be the most comprehensive US tax overhaul since 1986. Congressional Republicans are also pushing for major tax reform, with House Speaker Paul Ryan promising the House of Representatives will pass a bill by the end of July of this year. There remains considerable work to be done, however, as House Republicans, Senate Republicans, the White House, and congressional Democrats each have different views as to how the Code should be reformed (with significant disagreements over proposals like a border adjustment mechanism). Final enactment of a reform bill, if it happens this Congress at all, is not likely to happen before the end of 2017 and could easily spill into 2018.

Hogan Lovells – 1 March 2017

# Contacts

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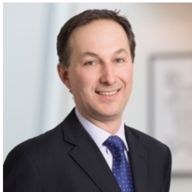

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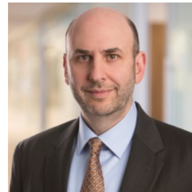

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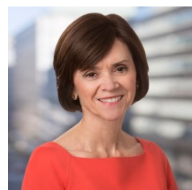

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