Investment Funds 2019 Update

Welcome to our annual Investment Funds Update, our briefing highlighting the key 2018 legal developments which impact the investment funds' industry and previewing what can be expected in 2019. Whilst Brexit has undoubtedly been the focus this past year and will continue to be so into 2019, there have also been a number of other key developments and upcoming proposals which it is important to be aware of. This Briefing will be relevant for managers and investors in a wide range of private and listed investment funds and includes links to our more detailed briefings on certain key topics. If you require any further details or would like to discuss further, please feel free to contact us.

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KEY ISSUES

Brexit and the alternative funds industry

The continuing evolution of the Brexit negotiations makes for uncertain times for alternative fund managers seeking to understand how their operations will be impacted by Brexit, not least for those trying to plan fundraising cycles in the short to medium term. With the publication of the draft Withdrawal Agreement, and accompanying Political Declaration on the future relationship with the EU, those within the alternative investment funds industry hoping for clarity on both the short term and long term position would have been disappointed.

The draft Withdrawal Agreement itself contains no provisions that are specific to the financial services sector. Interestingly, the draft Withdrawal Agreement does make reference to the fact that the UK will seek to retain access to the European Investment Bank. The European Investment Fund, of which the European Investment Bank is the majority owner, has provided significant sums to UK venture capital and lower mid-market private equity funds over the years and this would, therefore, be a welcome retention.

The Political Declaration does, by contrast, contain explicit reference to financial services with the inclusion of three high-level commitments by the EU and the UK:

- *"preserving financial stability, market integrity, investor protection and fair competition, while respecting the parties' regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the parties' ability to adopt or maintain any measure where necessary for prudential reasons;*
- *commencement of equivalence assessments by both parties as soon as possible after the United Kingdom's withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020; and*
- *close and structured cooperation on regulatory and supervisory matters, grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability, recognising this is in the parties' mutual interest."*

The political response in the UK to the draft Withdrawal Agreement and Political Declaration makes it all the more likely that we will see significant volatility in the coming months. Should a deal be ratified and a transition period put in place, it is reasonable to assume that the provisions governing the transition period will temporarily maintain existing rights of access for UK and EU firms by preserving the application of EU law during that time. However, the transition period will also require the UK to continue to implement new EU investment funds legislation which takes effect during that time. This means that the UK may potentially be required to implement some very significant measures which are currently being negotiated, including resultant legislation from the upcoming reviews of the AIFM Directive and the PRIIPs regime, in addition to the new legislation relating to the cross-border distribution of investment funds (frequently referred to as the "**Omnibus**" package).

During the transition period, the UK will have no formal representation in EU institutions which would otherwise permit it to participate in the legislative negotiations. Ultimately, this may result in new investment funds regulations reflecting more strongly the business models used in, and the regulatory (and political) priorities of, continental Europe, with no attention paid to UK-specific interests.

Unless the Article 50 period is extended, or revoked, the UK will leave the EU on 29 March 2019 at 11pm GMT. Those most affected by a no-deal Brexit would be UK full-scope AIFMs relying upon a managing or marketing passport. As the UK will immediately become a third country in the event of a no deal Brexit, such AIFMs will no longer be able to rely upon passporting regimes and will instead only be able to market under NPPR. It remains to be seen whether the passporting regime will be extended so as to include the UK (and other non-EEA jurisdictions); whilst the EU made significant progress with the third county passport regime prior to the referendum, there are currently no indications of such an extension being granted prior to withdrawal day.

Full-scope AIFMs established in other EEA Member States would no longer be able to manage a UK AIF or to market to UK investors under the AIFM passport in the event of a no deal Brexit. To address this, the FCA has proposed a temporary permission regime and has directed affected firms to notify the FCA now if they intend to use the regime. Firms must complete and submit the relevant forms during an allocated landing period between 7 January 2019 and 28 March 2019. The temporary regime is fund specific and will not apply to any AIFs that have not been previously marketed or notified. As such AIFs will instead have to be marketed under the UK NPPR.

Sub-threshold AIFMs will not be affected to the same extent as full-scope AIFMs; having never had access to the AIFM directive passport, they will continue to market under the NPPR. Similarly, non-EEA AIFMs would also continue to market under NPPR.

A key issue yet to be resolved is the fact that (both full-scope and sub-threshold) AIFMs marketing under the NPPR set out in Article 42 of the AIFM directive 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. Agreeing the terms of such co-agreements should not be controversial; the primary issue is having all relevant co-operation agreements in place in time. Encouragingly, ESMA announced that it is aiming to have such co-operation agreements in place by March 2019. Further, the European Commission has given direction to European Supervisory Authorities to start preparing cooperation arrangements so as to ensure that the exchange of information is possible immediately after the withdrawal date in the case of a no deal scenario.

In the UK, a raft of papers have been published in readiness for a no deal Brexit. These include the publication by HM Treasury of draft detailed regulations that will replace the AIFM directive and the PRIIPs regulations from the withdrawal day. Both drafts are stated to largely take the existing rules and onshore them, with changes having only been made where thought necessary to address any deficiencies caused by Brexit. The Financial Markets Law Committee has, however, in its report highlighted a number of legal uncertainties caused by the drafting proposed by the draft Alternative Investment Fund Managers (Amendment) (EU Exit) Regulations 2018 and these would certainly need to be addressed ahead of 29 March.

Further details of the HM Treasury and FCA's Brexit proposals for investment funds are in our client briefing here.

PRIIPs regulation: one year on

In January 2018, the Packaged Retail and Insurance Based Products ("**PRIIPs**") regulation came into effect. The EU investor protection initiative requires a short, standardised disclosure document containing key information about the product being offered, a key information document ("**KID**") to be produced and published for investment products marketed to retail investors in the EEA.

The industry has encountered seemingly endless issues with the regime. Complications arise due to the KID disclosure requirements being highly prescriptive and not lending themselves well to the nature of alternative funds as well as an inconsistent interpretation of the rules by market participants, in particular in respect of the approach taken to costs disclosures. There are also onerous obligations on the PRIIP manufacturer to keep the KID updated.

For private funds, issues arise as to the scope of the PRIIPs regime itself in relation to the small number of instances where a manager wishes to market a fund to individuals, including high-net worth and/or sophisticated investors participating in carried interest offers and/or staff or friends and family co-investment arrangements. Although private funds are not typically marketed to retail investors, certain individuals may not meet the definition of a professional investor as it is very difficult to 'opt-up' individuals to professional status.

In July, the PRIIPs regulation was the subject of a FCA Call for Input asking for feedback on initial experiences with the requirements of the PRIIPs regulation. In response, various industry bodies in their responses to the FCA, including the BVCA and the AIC, called for the relevant KID rules to be suspended, pending reform of the regime. The deadline for responses was in September 2018 and the FCA intends to publish a feedback statement on the Call for Input in early 2019. The FCA has stated that the responses to the Call for Input will inform its future engagement on the PRIIPs regulation with the ESAs.

In November, the Joint Committee of the European Supervisory Authorities ("**ESAs**") launched a limited and targeted consultation on what the ESAs identified as the most pressing issues relating to KIDs (most notably, relating to changing the approach for performance scenarios) which does not address the more fundamental issues with the regime. The European Commission was due to review the PRIIPs regulation by the end of 2018 but deferred the review in order to allow for the collection of robust evidence and data. Details of the ESA's consultation are in our client briefing.

In December, the European Parliament's Committee on Economic and Monetary Affairs ("**ECON**") voted in favour of postponing the deadline for the PRIIPs review by one year to **31 December 2019** and extending the UCITS exemption by two years to 31 December 2021. In response, the AIC stated in a press release that "*the KID should be suspended for all products to allow time to fix the problems once and for all. If KIDs are not good enough for UCITS investors, then they are not good enough for purchasers of investment companies*". The AIC took the decision earlier in the year (in May 2018) not to host KIDs on its consumer website as it felt that it would not be responsible to do so.

PRIVATE FUNDS

UK LP Act reform

In April 2018, the Department of Business, Energy and Industries Strategy ("**BEIS**") published a consultation on proposed reforms in respect of limited partnerships. The consultation has been published in response to concerns that Scottish limited partnerships ("**SLPs**") are being used in illegal activities. BEIS has taken the opportunity to consider how effective controls can be built into the entire lifecycle of limited partnerships. The proposals cover all UK limited partnerships, not only SLPs.

Following the end of the consultation, in December 2018 BEIS published its response to its consultation. The response paper sets out how the UK Government plans to implement changes to the Limited Partnerships Act 1907 ("**LP Act 1907**") in light of the responses to the consultation and other views gained through the wider consultation process. BEIS states that it intends to take action that will limit the potential misuse of limited partnerships but, at the same time, ensures that limited partnerships remain attractive for legitimate business use, in particular as an investment vehicle. This intention is reflected in the key issues covered in the response paper, which are not as onerous as those proposed in the initial consultation.

The proposals, as set out in the response paper, include:

- stronger registration requirements. BEIS intends to make it mandatory for any person presenting an application to register a limited partnership under the LP 1907 Act to provide evidence that it is being supervised by an appropriate AML body. One consequence of this is that direct registrations of limited partnerships by unregistered persons will no longer be possible. For UK limited partnerships established for the investment funds industry, however, this should not create a problem as the vast majority of such partnerships are established by firms of lawyers and accountants. Such firms are regulated by one or more of the UK's supervisory authorities, and are obliged to conduct anti–money laundering checks on their clients (typically the general partner or an affiliate). Note that an in-house lawyer working at a firm which was not registered with the FCA, or another AML supervisory body, may find that he/she cannot make direct registrations (although this would be unusual);

- BEIS originally proposed that a limited partnership should have a "meaningful connection" with the UK, either by maintaining a 'principal place of business' in the UK for the life of the limited partnership, or by having a service address in the UK. This proposal has now been dropped. This was a proposal that received significant pushback from the industry because of the desire to retain flexibility to 'migrate' a UK limited partnership to another jurisdiction (e.g. Jersey or Guernsey).

Instead, the response paper states that when the application for registration of the limited partnership is made, it must contain a proposed PPoB in the UK. On an ongoing basis, the limited partnership will then need to demonstrate that it maintains an ongoing connection to the UK, which can be via one of three routes:

- by retaining its PPoB in the UK;

- demonstrating that it is continuing some legitimate business activity at a UK address; or

- demonstrating that it continues to engage the services of an agent that is registered with a UK AML supervisory body and which has agreed to provide its address as a service address for the limited partnership.

Where the limited partnership does not retain its PPoB in the UK, it must notify the Registrar. If the way in which the limited partnership demonstrates its ongoing connection to the UK changes, it will also need to notify the Registrar. BEIS is still considering what evidence will be required to demonstrate the ongoing connection in each case. BEIS is also considering how these requirements should apply to existing limited partnerships and whether transitional arrangements will be required;

- an annual confirmation statement, confirming that all information on the Register at Companies House is correct. BEIS will introduce a transitional period for existing limited partnerships to provide additional information to cover all of the above requirements. BEIS will also undertake further work to determine whether it should require beneficial ownership information from corporate LPs or GPs who do not already have a PSC register;

- giving the Registrar powers to strike-of limited partnerships in similar circumstances to companies, to avoid there being many limited partnerships listed on the Registrar that are no longer active and/or have been dissolved.

- perhaps the most controversial proposal for the private funds industry, that of the introduction of the requirement to prepare and file annual report and accounts, has been dropped.

The response paper does not contain specific proposed draft legislation with the government only committing to legislation "when parliamentary time allows", presumably due to Brexit.

Our earlier briefing, with a detailed analysis of the consultation proposals, is available here and our briefing covering the response paper is here.

ILPA: Portfolio Company Metrics Template and diversity and inclusion resources

In August 2018, the Institutional Limited Partners Association ("**ILPA**") published a draft Portfolio Company Metrics Template which standardises the format for investors to request information from general partners. The template is designed specifically for buyout and growth equity funds. Specifically, the template is designed to help limited partners measure:

- portfolio risk exposure across geographies, sectors, and strategies;

- value creation across individual funds, in addition to the portfolio;

- limited partnership agreement / side-letter compliance; and

- attribution for significant changes in company valuations.

The consultation ended in September.

Also published by ILPA this year were resources as part of its work on advancing diversity and inclusion within the private equity industry. Importantly for fund managers, these include an expansion to ILPA's standard due diligence questionnaire to include a new section of questions covering a general partner's policies and procedures in areas such as hiring, promotions, family leave, mentoring, and harassment and discrimination. The questionnaire includes a template for managers to report on the race/ethnic and gender diversity in their teams.

The new resources also include guidance for general partners, limited partners and fund portfolio companies on developing codes of conduct on harassment, discrimination and workplace violence.

ILPA to publish guidance on GP-led restructuring

It has also been widely reported in the press that ILPA will shortly be updating its private equity principles with guidance on GP-led restructurings.

The guidance is being prepared in response to concerns among ILPA members about such transactions. In terms of what will be covered by the ILPA guidance, ILPA's chief executive Steven Nelson has said *"our focus has been on how to evaluate the risks associated with GP-led transactions, how to be sure LPs are identifying the right sort of information they should be requesting in order to make an informed decision, and – stating the obvious – being aware of and sensitive to potential conflicts that can exist in those types of transactions*". Following the publication of the guidance, it would be reasonable for GPs to expect additional queries from potential investors in relation to GP-led restructurings.

EuVECA regulations amended

In March 2018, the EuVECA regulation, amended by way of Regulation (Regulation (EU) 2017/1991) (the "**Amending Regulation**") in November 2017, came into effect. This followed the European Commission's decision to accelerate the regulation's review and to bring it forward as part of its Capital Markets Union Action Plan.

A number of helpful amendments were made to the EuVECA regime, which primarily relate to:

- increasing the range of managers eligible to set up and manage EuVECA funds so as to include those with assets under management of more than EUR500 million;
- providing greater flexibility on eligible investments; EuVECAs can now invest in unlisted companies with up to 499 employees;
- opening up the EuVECA designation to all AIFMs, enabling EuVECA registered managers to market their funds across the EU; and
- giving ESMA an oversight role to ensure that funds are consistently registered and supervised.

The amendments were brought in on an accelerated timetable due to the low uptake: in the first 2 years of the regime, only 34 EuVECA funds were registered (raising EUR 1.3bn in capital).

IPEV publishes draft amendments to its Valuation Guidelines

In October 2018, the International Private Equity Valuation Board ("**IPEV**") published draft amendments to the International Private Equity and Venture Capital Valuation Guidelines (the "**Valuation Guidelines**") for consultation. The Valuation Guidelines, which were last updated in 2015, set out recommendations intended to represent current best practice, on the valuation of private capital investments. The term "private capital" is used in the Valuation Guidelines in a broad sense to include privately held (i.e., unlisted) investments in early stage ventures, management buyouts, management buyins, infrastructure, credit and similar investments and investments in funds making such investments. The guidelines also provide a basis for valuing investments by other entities, including fund-of-funds, in such private capital funds.

Key proposed amendments included in the draft include:

- the price of a recent investment has been removed as a valuation technique to reinforce the premise that the fair value of the investment must be established;
- the valuation considerations for early-stage investments have been expanded, which will be of assistance to VC firms; and
- the guidance on valuing debt has been expanded.

A number of technical clarifications have also been incorporated. Karin Lagerlund, IPEV Board member, says: "*limited partners need their general partners to provide robust estimates of fair value, consistent with accounting standards. Applying the IPEV Valuation Guidelines helps GPs demonstrate to LPs the rigour applied in estimating fair value. The expansion of guidance on determining the fair value of debt investments is in response to the needs of investors and the fact that accounting standards require that debt investments of investment entities/investment companies be measured at fair value.*"

The consultation ended in November and IPEV intends to publish the finalised version such that it will be in effect for reporting periods beginning on or after **1 January 2019**.

11th Annual PERG Report

In December 2018, the 11th 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 2018 report contains the results of a review of 56 portfolio companies that fall within the scope of the guidelines and the 51 private equity firms and those operating in a private equity-like manner that back them.

The key findings of the 2018 report are:

- all portfolio companies reviewed in the sample complied with the disclosure requirements in the annual report this year (2017: 79%);
- comparing only those portfolio companies that have complied with all of the disclosure requirements in their annual reports, 73% prepared disclosures to a good standard (2017: 80%);
- 81% of portfolio companies have published an annual report in a timely manner on their website (2017: 78%);
- 74% of portfolio companies have published a mid-year update in a timely manner on their website (2017: 72%);
- 7% of portfolio companies have not complied with any of the three components of the guidelines that apply to them this year (2017: 12%). These companies are backed by non-BVCA members;
- all BVCA members have published certain disclosures on their own websites to communicate information about the firm, its portfolio companies and its investors as required by the guidelines or provided an explanation; and
- 85% of portfolio companies have provided data, which is presented in aggregate in the Ernst & Young performance report published alongside the PERG report (2017: 85%).

LISTED FUNDS

Prospectus Regulation

In July 2018, the Prospectus Regulation introduced a change to the consideration threshold which takes an offer of securities outside the scope of the prospectus regime. Previously, the threshold was EUR 5 million (this refers to the total consideration of the offer in the EU, calculated over a period of 12 months). Since July, EU Member States have been able to set out in their national law a threshold between EUR1 million and EUR8 million, from which the exemption should apply taking into account the level of domestic investor protection they deem to be appropriate. The UK has (helpfully) exercised its discretion such that the threshold has increased from EUR 5 million to EUR 8 million (calculated on an EEA-wide and 12 month basis). This follows the change introduced earlier (in 2017) to the threshold exemption for secondary or tap issues, which was increased from 10% to 20% (of the number of shares of the same class already admitted, calculated on a 12 month basis).

The remainder of the provisions of the Prospectus Regulation will come into force in **July 2019**. The Prospectus Regulation, which will repeal and replace the existing Prospectus Directive, seeks to simplify the current prospectus regime and forms a key part of the European Commission's Capital Markets Union project. The Prospectus Regulation as such represents an improved and modified regime, rather than a complete overhaul of the existing regime.

The most significant changes to the current regime will be:

- ***Secondary Issues***: a new simplified proportionate disclosure regime for certain secondary offerings will be introduced. The detailed disclosure requirements will be set out in delegated acts; the Prospectus Regulation requires these disclosure schedules to include, in particular, annual and half-yearly information published within the last 12 months preceding the approval of the prospectus, profit forecasts and estimates (where applicable), a concise summary of relevant information disclosed under the Market Abuse Regulation in that 12-month period and a working capital statement. The more specific content requirements are contained in ESMA's final report (technical advice) published in March 2018, which will form the basis for the necessary delegated acts;

- ***Summary***: certain changes as to form and content of the summary. The Prospectus Regulation requires the summary to be made up of four main sections: (i) an introduction; (ii) key information on the issuer; (iii) key information on the securities; and (iv) key information on the offer of securities to the public and/or the admission to trading on a regulated market. Within these main sections, specific information must be included, set out in a Q&A form. ESMA has published its final report on the draft regulatory technical standards ("**RTS**") which includes (among other items) the key financial information to be included in the summary. The information required depends on the type of issuer and types of securities involved and will be presented in tabular form according to the tables set out in the draft RTS. The summary length must be no more than seven pages;

- ***Shelf Registration Document***: the concept of a Universal Registration Document –this will allow issuers to have a "shelf" registration document; if the document is filed with a competent authority and approved for two consecutive years , the company will achieve 'frequent issuer status' and all subsequent Universal Registration Documents may be filed without prior approval and reviewed on an ex-post basis. Once in place, a Universal Registration Document can be used to form a prospectus, with the addition of a securities note and summary. The primary benefit of producing a Universal Registration Document is that it will also entitle the issuer to a fast-track approval process for a prospectus, halving it from 10 to 5 working days (subject to certain conditions);

- ***Risk Factors***: changes are being made to the presentation of risk factors, and limiting the risk factors included to those specific to the issuer or the securities in question and material to making an informed investment decision. Risk factors will need to be categorised, and set out in order of their materiality, with issuers having the option to include a qualitative scale of low, medium or high. The most material risk factors must also be included in the summary (limited to a maximum of 15). Draft guidelines on risk factors were published by ESMA in July 2018;

- ***Incorporation by Reference***: the extension of the categories of information which may be incorporated by reference into a prospectus. Most notably, the extended list of information will permit an issuer to incorporate by reference any type of 'regulated information' (as that term is defined in the Transparency Directive). Currently, such regulated information can only be incorporated by reference if it has been filed or notified with the Home State. The Prospectus Regulation also includes a list of documents which may be incorporated by reference and which includes management reports and corporate governance statements;

- ***Supplementary Prospectus***: new obligations are being imposed on financial intermediaries where a supplementary prospectus is required, requiring intermediaries to contact investors on the day of publication of a supplementary prospectus to inform them of their withdrawal rights; and

- ***Publication***: certain changes are being made to the methods of publication for a prospectus. A prospectus will be deemed available to the public when published on the website of the issuer, the relevant financial intermediaries or the regulated market where the admission to trading is sought. The currently available options of publishing a prospectus in printed form at the offices of the issuer, regulated market or financial intermediary will no longer be available. Further, a prospectus in a 'durable medium' must be delivered to an investor on request; this would include floppy disks, CD-ROMs, DVDs and PDF documents.

The final reports for ESMA's streams of work are due by 31 March 2019 and will form the basis of the necessary delegated acts. For a summary of the provisions contained in the Prospectus Regulation, see our client briefing here.

ESMA Q&A on prospectuses: profit forecasts

In March 2018, ESMA published a new version of its Q&A on Prospectuses, which included a new question on identifying profit forecasts. The 2004 EU Prospectus Regulation defines a profit forecast as: "*a form of words which expressly states or by implication indicates a figure or a minimum or maximum figure for the likely level of profits or losses for the current financial period and/or financial periods subsequent to that period, or contains data from which a calculation of such a figure for future profits or losses may be made, even if no particular figure is mentioned and the word "profit" is not used.*"

The principal points of the ESMA guidance on the definition are as follows:

- no minimum or maximum figure is required – the statement may refer to a range, or a maximum or minimum figure may be implied;
- the forecast may not necessarily refer to the "profits" as stated in the profit and loss account, but may include other measures of profitability e.g. EBITDA. In the context of financial measures that may be viewed as profit forecasts, ESMA adopts a "substance over form" approach;
- information need not relate to the entirety of an issuer's results to amount to a profit forecast (for example, where one segment of the issuer's business generates the vast majority of its profit and predictions are made about the level of that segment's profit);
- a stated hope or aim may on its own amount to a profit forecast, particularly if a specific figure is stated;
- profit forecasts are distinct from trend information required under Annex 1 of the Prospectus Regulation. Forecasts should be clearly identified as such; and
- saying that a statement is not a profit forecast will achieve nothing if that is what it is.

FRC's updates to the Corporate Governance Code, AIC corresponding updated Code

In July 2018, the FRC published a revised UK Corporate Governance Code, which will take effect for financial years beginning on or after **1 January 2019.** Most notably, the updates include a limit on tenure for a Chairman to 9 years (which applies to the entire period of the Chair's service on the board, i.e. it is not limited to the period that a director serves as the Chair). In September, the AIC published draft updates to its own AIC Code. The AIC disagrees with the Chair tenure limit provision but has included it in the draft AIC Code so as to preserve FRC endorsement of the AIC Code. The AIC therefore sought member input on whether the provision should be included or not.

Following this input, in December 2018 the AIC has stated that it has approached the FRC to see whether the AIC Code could depart from the UK Code in relation to:

- the UK Code's prohibition on the Chair being a member of the Audit Committee; and
- limiting the tenure of the Chair to nine years.

The AIC has indicated that the final version of its updated AIC Code will be made available in the first few weeks of 2019.

FCA publishes Dear CEO letter on irredeemable preference shares and similar capital instruments

In April 2018, the FCA published a "Dear CEO" letter on irredeemable preference shares and other similar capital instruments. The FCA states that it wants investors to have access to the information that they require in order to properly assess the risks and rewards attaching to such shares. It refers to Aviva's recent announcement relating to its ability to cancel certain irredeemable shares it had issued at, or close to, nominal value through a reduction of capital under the Companies Act

2006. Aviva's announcement affected the market for, and price of, these shares. The market price of some other similar shares issued by other listed companies also fell at the same time. Aviva subsequently stated that it had decided not to cancel its irredeemable preference shares.

The FCA states that listed companies will need to look at whether an intention to cancel a class of irredeemable shares, at a price based on factors other than the prevailing market price, will constitute inside information under the Market Abuse regulation. Companies should ensure that certain information is made available to all shareholders and potential shareholders, including:

- the terms and conditions of the instrument;
- details of any changes that have been made after the issue of the shares;
- the articles of association, in particular, the terms relevant to the shares concerned; and
- a "Q&A" publication (or similar), including clarification on:
  - (i) the extent to which rights attaching to the shares can be changed by the company without a specific resolution of the affected class;
  - (ii) any ability to cancel the shares at a price less than the prevailing market price without the specific assent of the affected shareholders; and
  - (iii) whether the company has made a decision regarding its approach to the use of (i) or (ii).

The FCA urges companies to consider whether there is a risk that the prevailing market price of any of the company's shares or other signals from investors suggest that there is a lack of understanding over the terms and conditions of those shares and/or the company's intention regarding them.

Pre-emption group statement on expectations for disapplication thresholds

In March 2018, the Pre-emption Group issued a statement in relation to the exemption introduced by the Prospectus Regulation, which allows companies with securities admitted to trading on a regulated market to issue, without a prospectus, securities representing less than 20% (increased from 10%) of the same class of securities that are already admitted to trading. The Pre-emption Group had stated last year that it continued to support the overall limit of 10%. It has now reiterated that, whilst decisions about specific placings are a matter for individual shareholders, its Statement of Principles relating to the disapplication of pre-emption rights reflects a generally agreed position supported by the Investment Association and the PLSA, and companies should be mindful of the expectations set out within it. It also reminds companies to use its template resolutions and Appendix of Best Practice in Engagement and Disclosure when applying for authority to disapply pre-emption rights and issuing shares under that authority.

Investment Association updates its principles of remuneration

In November 2017, the IA wrote to the chairmen of remuneration committees of FTSE 350 companies to outline the key changes to The Investment Association Principles of Remuneration for 2018, and to highlight the items of focus for the 2018 AGM season. Following extensive changes to the Principles for 2017, the changes for 2018 are mostly incremental and only relevant to internally managed funds. The main rule change is a requirement for long term incentives and bonuses paid as shares to have a minimum 5 year vesting and post-vesting hold period (in total).

GC100 guidance on directors' duties – Section 172 revisited

In October 2018, GC100 published guidance for directors on section 172 and stakeholder considerations.

The guidance includes examples of practical steps directors could take to discharge the section 172 duty, such as:

- reflecting the section 172 duty when setting and updating the company's strategy.

- establishing and attending training courses on induction to the board, with ongoing updates on the section 172 duty in the context of the director's wider duties and responsibilities.

- considering, and arranging to receive, the necessary information on appointment and subsequently to carry out the role and satisfy the duty.

- putting in place policies and processes to support the company's operating strategy and support its goals in the light of the section 172 duty. Suggestions are made for boards, managers, directors of UK subsidiaries and directors of UK joint venture companies.

- considering the company's approach to engagement with employees and other stakeholders, whether through board engagement or wider corporate engagement; how stakeholders experience the company, its board and management through day to day interactions as well as specific channels; the extent to which engagement feedback is communicated back the company; and whether the company does what it says it does for stakeholders.

Considering how to embed in the habits and behaviour of board, management and employees, a culture which is consistent with the company's goals in relation to stakeholders, whether employees, customers, suppliers, local communities, the environment or others affected by or engaging with the company's activities.

Please see here a link to our client briefing on this matter.

AIM Rules updated

In March 2018, revised AIM Rules for Companies and AIM Rules for Nominated Advisers took effect. The new rules require an AIM company to disclose on its website details of how it complies or explains against a 'recognised corporate governance code', as chosen by the board of directors. The LSE has not sought to prescribe a list of 'recognised codes'. It remains of the view that it is "preferable for AIM companies to have a range of options to suit their specific stage of development, sector and size".

New applicants will need to state their chosen corporate governance code upon admission, but all AIM companies had until 28 September 2018 to comply with the new requirement, which obliges them to state how they comply with their chosen code (and provide explanations where they do not comply).

The LSE has also published a template for nominated advisers to use to provide early notification of information on AIM applicants. This can be found under the form's section on the LSE's website.

The LSE has clarified that compliance will need to be reviewed annually and the website should include the date of the last review. For further details, please see our client briefing on this topic.

EU Shareholder Rights Directive – Commission consultation on minimum requirements

In April 2018, the EU Commission launched a consultation seeking feedback on a draft implementing regulation in relation to the EU Shareholder Rights Directive, as amended by the Amending Directive. The Amending Shareholder Rights Directive came into force in June 2017 and member states have until June 2019 to transpose its provisions into national law.

The draft regulation sets out minimum requirements as regards certain aspects of the EU Shareholder Rights Directive, namely:

- shareholder identification;

- the transmission of information; and

- the facilitation of the exercise of shareholder rights.

The draft regulation specifies standardised formats and minimum content requirements in relation to a range of documents, including requests to disclose information regarding a shareholder's identity; notices of general meetings and forms of confirmation of the receipt and counting of votes.

Listing Rules and DTRs: minor changes (Listing Principles and diversity policy disclosure)

In July 2018, the FCA published Handbook Notice No 57 which contains its feedback on the nineteenth quarterly consultation paper (CP17/39) which proposed certain minor amendments to the Listing Rules and DTR. The following rule changes were made:

- Premium Listing Principle 6 in LR 7.2.1AR (which requires a listed company to ensure that it communicates information to holders and potential holders of its listed equity shares in such a way as to avoid the creation of a false market in those shares) has been amended to insert the words "or continuation" after "creation". This reinstates the former wording and ensures that the principle covers both the continuation and the creation of a false market; and
- it has been clarified that the information on a company's diversity policy (as required under DTR 7.2.8AR) must be included in the corporate governance statement in its directors' report and that such statement can be set out in a separate report published together with the annual report or, alternatively, in a document published on the company's website.

TAX

Non-residents and UK real estate

From 6 April 2019 non-UK residents will be subject to UK tax on gains from disposals of all UK property, including commercial property. This is a radical change given that, at the moment, the UK only taxes gains from UK residential property (and exempts some diversely-held companies and widely-marketed funds from this charge). Re-basing to market value as at 5 April 2019 will apply to property currently out of the scope of UK tax.

In addition, non-UK resident investors will be taxed on disposals of interests in "property rich" entities (broadly, companies or other entities which derive not less than 75% of their value from UK land). Again, rebasing will apply. In the case of companies, the seller will need to have had a 25%+ stake in the entity at some point in the two years prior to the sale for the charge to apply, however, this threshold requirement is generally switched off in relation to direct disposals of interests in property rich collective investment vehicles (and certain other scenarios relating to such vehicles). Note that some of the UK's tax treaties (most notably Luxembourg) do not give it the right to tax non-residents on sales of property-rich entities. The rules will include a wide ranging anti-avoidance provision which will need to be considered for all structures.

A high-level reminder of the current position for property income and gains arising to non-resident individuals and corporates (but not funds), and a summary of how it is going to change, included as part of our Budget mailing in October 2018, can be found here.

The draft legislation implementing this new tax charge was first published in July 2018, but the draft did not contain any bespoke provisions for collective investment schemes. Instead, HMRC set out some high level proposals and acknowledged that further work was required in this area. After an informal consultation process the draft rules for collective investment vehicles were published on 7 November 2018. These rules have generally been well received and many of the concerns raised during consultation have been addressed, but the rules are long and complex and there remains a degree of uncertainty in certain areas. Please click here for a link to an article published in the Tax Journal in December 2018 which summarises how the new rules apply for funds.

Stamp duty and SDRT: New market value rules for transfers between connected persons

In the 2018 Autumn Budget the government announced changes to the charge to stamp duty and SDRT on the transfer of listed securities to a company which is connected with the transferor. With effect from 29 October 2018, the transfer of (or agreement to transfer) such listed securities is deemed, for stamp duty and SDRT purposes, to be for consideration equal to the higher of: (i) the amount or value of the consideration (if any) for the transfer; or (ii) the market value of the securities.

In addition, the government published a consultation on 7 November 2018 on aligning the stamp duty and SDRT consideration rules, as well as on the possibility of introducing a more general connected party market value rule (i.e. extending the new market value rule for listed securities which came into effect from 29 October 2018 to unlisted securities and connected party transfers other than to companies). We will be keeping a watching brief on the progress of the proposals and will keep you updated, as HMRC has highlighted that they may impact on funds.

Base erosion & profit shifting ("BEPS"): UK perspective

The UK government has expressed keen support for the BEPS project. The UK government is in the process of implementing (or has implemented) the OECD's recommendations on Action 2 (Hybrids), Action 4 (Interest deductibility), Action 5 (Harmful tax practices, including patent box) and Action 13 (Country-by-Country reporting). Some technical amendments will be made to the UK's existing anti-hybrid rules and controlled foreign company rules in the Finance Bill 2019 in order to ensure compliance with the EU Anti-avoidance Directive ("**ATAD**").

The UK has signed up to, and ratified, the OECD's Multilateral Instrument ("**MLI**") (Action 15). The MLI entered into force for the UK on 1 October 2018. The UK has adopted the MLI treaty abuse principle purpose test provisions in its double tax treaties. The UK has not adopted the MLI permanent establishment changes to the "dependent agent"/"independent agent" test or the specific activity exemptions, but it has adopted the anti-fragmentation rule (and the relevant UK domestic legislation is being amended by Finance Bill 2019 to reflect this). The UK has signed up to much of the dispute resolution actions implemented by the MLI, and is one of the few countries committed to binding arbitration.

BEPS Action 1 deals with addressing the tax challenges of the digital economy. The government announced in the Autumn Budget that it will introduce a digital services tax which is to apply from April 2020.

Avoidance involving profit fragmentation

The Finance Bill 2019 contains new rules aimed at preventing UK traders and professionals from avoiding UK tax by arranging for their UK-taxable business profits to accrue to non-UK resident entities in jurisdictions where significantly lower tax is paid than in the UK. The new rules targeting such 'profit fragmentation arrangements' will have effect from 6 April 2019 for income tax purposes and 1 April 2019 for corporation tax purposes.

The new rules were first announced at the Autumn Budget 2017 with draft legislation published in June 2018. Following consultation over the summer, revised draft legislation was published on 7 November 2018. The revised draft legislation addresses some of the concerns which had been raised with the original draft. In particular, the obligation to report potentially profit fragmentation arrangements to HMRC has been removed.

Helpfully, the new rules contain a defence for transfer priced arrangements.

Entrepreneurs' relief

Several amendments to the entrepreneurs' relief rules were announced as part of the 2018 Autumn Budget. In particular, it was announced that, with immediate effect (i.e. from 29 October 2018), in order for entrepreneurs' relief to be available on a disposal of shares, additional conditions would need to be met in relation to nature of the relevant individual's shareholding. The policy objective behind the introduction of these new conditions is to ensure that an individual has a true material stake (broadly at least a 5% economic interest) in a company in order to be able to claim entrepreneurs' relief in relation to it.

The provisions of the Finance Bill 2019 which implement these changes (which were first published on 29 October 2018), have gone through some recent amendments following representations from industry bodies. These recent amendments deal with some of the concerns which had been raised around the practical application of the new provisions. However, broadly speaking, it remains the case that the changes require that an individual must have at least a 5% economic interest in a company in order to claim entrepreneurs' relief in relation to it.

Entrepreneurs' relief is very commonly used by asset managers to incentivise management teams of portfolio companies and any entrepreneurs' relief planning that is currently in place should be revisited in light of the changes being implemented by Finance Bill 2019 (which have effect from 29 October 2018).

Please click here for our Budget mailing on changes to entrepreneurs' relief. The mailing sets out the position as announced at the time of the Budget and so does not reflect changes made to the relevant provisions since that time.

Mandatory disclosure rules for cross-border arrangements (DAC 6)

Finance Bill 2019 contains provisions which empower HM Treasury to make regulations to implement the EU's DAC 6 (Directive for Administrative Co-operation in the field of Taxation) rules and the OECD's model mandatory disclosure rules. HMRC has confirmed that these regulations will be implemented by 31 December 2019, as required by DAC 6. Please click here for a brief summary included as part of our Budget briefing in October 2018, which summarises what DAC 6 is and why it is relevant for asset managers.

VAT grouping

Finance Bill 2019 includes measures which extend the UK's VAT grouping rules. The current proposals are for two new types of VAT group, as follows:

1. an individual carrying on a business and one or more UK bodies corporate can be a VAT group where the individual controls the corporate and the individual is established, or has a fixed establishment, in the UK in relation to the business; and

2. a partnership carrying on a business and one or more UK bodies corporate can be a VAT group where the partnership controls the corporate and the partnership is established, or has a fixed establishment, in the UK in relation to the business.

These are additional to the existing type of VAT group, and we understand from HMRC that there is no intention for these new groupings to change the way any existing VAT group rules work.

The commencement date for these measures has not yet been announced, but the earliest it could be is the date the Finance Bill 2019 receives Royal Ascent (which should be early this year). The government consulted on a wider range of changes to the VAT grouping rules, and we will keep reviewing developments in this area as and when they are announced.

Tax charge for disguised remuneration loans which are outstanding on 5 April 2019

It was announced at the 2016 Budget (and enacted in Finance (No.2) Act 2017) that a one-off tax charge would apply to disguised remuneration loans which were still outstanding on 5 April 2019, unless the loan has been approved by HMRC or the individual has agreed a settlement with HMRC prior to this 5 April 2019 deadline. The charge applies to loans which were made on or after 6 April 1999, which fall within: (a) one of the gateways of the disguised remuneration rules for employees, or (b) the new self-employed disguised remuneration rules, and which are outstanding (in whole or in part) at the end of 5 April 2019.

By way of background:

(i) the main gateway to the disguised remuneration rules, which applies to employment income routed through third parties (including arrangements involving loans being provided by third parties), only applies to transactions entered into from 9 December 2010,

(ii) the new close companies' gateway (introduced in Finance Act 2018), which extended the disguised remuneration rules to apply to certain arrangements involving a close company where there is a tax avoidance purpose, only applies to transactions entered into from 6 April 2018, and

(iii) a parallel regime was introduced (by Finance (No.2) Act 2017) in respect of self-employed individuals, which effectively extended the disguised remuneration rules to apply to self-employed traders, only applies to transactions entered into from 6 April 2017.

The effect of the one-off tax charge is to attack any loans made on or after 6 April 1999 which were entered into before the rules set out above came into in force, but which would have been caught had any of the rules been in force at such time.

The retrospective nature of the one-off charge, and the 5 April 2019 deadline, have attracted much public criticism. This criticism recently led to a late amendment to the Finance Bill 2019 which requires that the government must provide a report on the issue by not later than 30 March 2019. There is currently nothing to suggest that the one-off charge or the 5 April 2019 deadline will be amended, but we will continue to monitor developments over the next few months.

Please do get in touch if you have any questions in relation to the application of the one-off tax charge ahead of the April 2019 deadline.

REGULATORY

Securitisation regulation

The EU Securitisation regulation took effect on **1 January 2019** and introduced a new, harmonised set of rules governing EU securitisations and investments in securitisations by EU institutional investors. In addition, revised regulatory capital rules in the Capital Requirements regulation governing investment in securitisation positions also took effect on that date. We previously summarised the key elements of these new rules in section 8 of our Financial Services New Year Briefing published in January 2018.

The Securitisation regulation also introduces new transparency reporting requirements for originators, sponsors or securitisation special purpose vehicles (depending on which of those entities is nominated to fulfil the reporting obligation). These rules require the relevant entity to make information available to investors, regulators and, upon request, to potential investors. ESMA, working jointly with the EBA and EIOPA (known collectively as the European Supervisory Authorities, or ESAs), was tasked with designing the relevant reporting templates for these purposes. However, due to the technical complexity of the task, the templates had not been finalised by 1 January 2019 when the reporting requirement technically began to apply.

In November 2018, the ESAs published a joint statement which acknowledged that the reporting templates were likely to be delayed and that transitional provisions in the Securitisation Regulation would therefore apply instead. The transitional rules require the nominated reporting entity to report using certain templates specified in the Credit Rating Agencies regulation (**CRA regulation**) until the new templates are adopted. However, the joint statement recognised that for firms that have not previously been required to report in accordance with the CRA regulation, implementing systems to facilitate such reporting on a temporary basis would be expensive and time-consuming. Accordingly, while noting that national regulators do not have the legal power to disapply the transitional reporting requirements, the ESAs stated that they nonetheless expected such regulators to apply day-to-day supervision and enforcement in a "proportionate and risk-based manner", taking into account the type and extent of information already being disclosed by reporting entities. The statement emphasised that the ESAs are not recommending general forbearance by regulators, but rather a "*case-by-case assessment…of the degree of compliance with the Securitisation Regulation*". The precise meaning of this is somewhat unclear, but it appears to indicate that where it is impractical or excessively expensive to implement the CRA Regulation templates, firms may be able to argue that they nonetheless already report substantively similar information to investors which broadly satisfies the underlying purpose of the legislation. UK firms should also continue to monitor for any future announcements by the FCA which may give further clarity on its intended approach to forbearance in this area.

New AIF and UCITS depositary delegation rules

In October 2018, two new delegated regulations were published in the EU Official Journal which amend the existing safekeeping requirements in the AIFMD Level 2 Regulation (Delegated regulation (EU) No. 231/2013) and the UCITS Level 2 regulation (Delegated regulation (EU) 2016/438). The new requirements will apply from **1 April 2020**.

The new rules will impact depositaries when they are delegating their functions to a third party custodian and introduce new requirements in relation to information rights, reconciliations and asset segregation. They will also introduce additional conditions that must be satisfied in the case of delegation by depositaries to non-EEA custodians. While the new rules are not directly applicable to AIFMs and UCITS managers, such firms should nonetheless consider whether they need to amend any existing depositary agreements in order to reflect the revised requirements.

We published a client briefing on these developments in November 2018 containing additional commentary on the new rules, which is available here.

FCA consultation on illiquid assets and open-ended funds (CP 18/27)

In February 2017, the FCA published a discussion paper (DP 17/01), which set out some of its concerns about ensuring adequate liquidity in open-ended funds investing in illiquid underlying assets. This issue gained particular prominence after the suspension of dealing in certain open-ended property funds following the outcome of the referendum on the UK's membership of the EU in June 2016.

In October 2018, the FCA published a consultation paper (CP 18/27) which discussed the feedback it received to the original discussion paper and set out a range of concrete proposals which are potentially relevant to the following types of entities:

- managers of open-ended funds investing in illiquid assets;
- depositaries of such funds; and
- intermediaries and platforms distributing units or shares in such funds.

Broadly speaking, a fund will be within scope of the proposed new requirements if it is a non-UCITS retail scheme (NURS) which invests, or intends to invest, at least 50% by value of the fund's property in inherently illiquid assets. For these purposes, inherently illiquid assets include:

- immovable property;
- infrastructure project investments;
- transferable securities that are not readily realisable securities; and
- units in another fund which invests in inherently illiquid assets.

However, a NURS will be excluded from the new requirements if its rules provide for limited redemption arrangements that reflect the typical time that would be needed to liquidate the inherently illiquid assets in which it invests.

Where a regulated firm is communicating a financial promotion (other than a prospectus or a key investor information document equivalent for a NURS) to a retail client relating to an in-scope fund, it will be required to provide that client with a new standardised risk warning drafted by the FCA. This requirement applies not just to the fund manager, but also to any other firm which is subject to the FCA's conduct of business rules. As a result, intermediaries (e.g. IFAs) and platforms will need to ensure that any financial promotions they make contain the disclosure, where relevant. Managers of in-scope funds will also need to include additional information in the fund prospectus relating to liquidity risks.

In addition, managers of in-scope funds will need to:

- implement new liquidity management contingency plans;
- obtain written confirmation from any third parties identified in those contingent plans that the third party is able to implement any relevant steps envisaged by the plan; and
- include the words " – a fund investing in inherently illiquid assets" in the final part of the fund's name at least once in any written communication that will be provided to or seen by retail clients.

Depositaries of in-scope funds must devise procedures for overseeing the fund manager's liquidity management and compliance with liquidity rules, as well as having a clear mechanism for escalating any instances of non-compliance with the relevant rules.

More generally, the FCA is also proposing certain additional rules which are currently expressed to apply to managers of all authorised funds. Such managers will need to:

- where the fund prospectus explicitly allows rapid sales of immovable property held in the fund's portfolio to meet redemption requests, agree a fair and reasonable price for the property with the fund's independent valuer; and

- for funds investing in property, suspend dealings in the fund's units if the independent valuer has expressed material uncertainty about the value of one or more immovable properties under management which are worth at least 20% of the fund's property (or if the fund has invested at least 20% of its property in other authorised funds whose dealing has been suspended for the same reason).

Firms which may be affected by these proposals have until **25 January 2019** to provide feedback on the consultation.

FCA discussion paper on climate change and green finance (DP 18/8)

In October 2018, the FCA published a discussion paper (DP 18/8) setting out its approach to climate change and green finance issues in financial services. The FCA noted that both climate change itself and the actions that governments may take in an attempt to combat it could have important effects on the financial markets, leading to changes in the risks associated with, and the value of, certain financial investments.

In light of these potential changes, the paper contains a number of observations and tentative proposals from the FCA on which firms are invited to provide feedback. These include the following, which may be relevant to fund managers:

- the possible introduction of additional minimum disclosure standards to ensure that investors understand the products that they are buying and to prevent "green-washing" (i.e. marketing which suggests that financial products produce positive environmental outcomes when this is not the case);
- the possible introduction of a more standardised framework for green finance disclosures to ensure better comparability between products;
- seeking input from the industry on whether any new green finance framework should take the form of principles applied on a "comply or explain" basis or whether another approach would be preferable; and
- publishing a future consultation on proposed new guidance for issuers of listed securities relating to how current regulatory rules might be interpreted to apply to risks arising from climate change.

The FCA's proposals in the discussion paper are separate from the sustainable finance proposals published by the European Commission in May 2018, although the FCA states that it will continue to engage with the EU institutions in relation to those initiatives and broader green finance policy.

Firms have until **31 January 2019** to respond to the discussion paper.

Senior Managers and Certification Regime

As most firms will already be aware, absent any unexpected developments, the Senior Managers and Certification Regime ("**SMCR**") will be extended to FCA solo-regulated firms on **9 December 2019**. As a result, UK fund managers that have not already begun to take steps to implement SMCR will need to begin doing so during the coming year.

The FCA's near-final rules in this area (which will effectively become the final binding rules when the relevant implementing legislation is enacted) were published in July 2018. The transition to the SMCR will work differently depending on the firm's classification, which in turn depends upon the size and complexity of the financial services activities it undertakes.

We published a client briefing in July 2018 explaining the latest key developments, which is available here. That briefing also links to our earlier briefings in July 2017 and December 2017 which provide further detail on the SMCR, including the proposed classification of firms for these purposes.

Omnibus directive and regulation: cross-border distribution of investment funds

In March 2018, the European Commission published two new legislative proposals which will amend the existing legal regimes for the cross-border distribution of investment funds in the EU. These proposals include a new directive ("**Omnibus directive**") which will amend the existing regimes for cross-border marketing of alternative investment funds ("**AIFs**") and undertakings for collective investment in transferable securities ("**UCITS**"), and a new regulation ("**Omnibus regulation**") which will introduce new standardised requirements for cross-border fund distribution in the EU.

The Council of the EU agreed its negotiating mandate on the legislative proposals in June 2018 and has published compromise proposals. The original proposals were felt to be unnecessarily prohibitive but, thankfully, the Council's agreement has addressed most of the concerns raised by industry.

The key points of the proposals are:

- the Omnibus directive and Omnibus regulation will amend the existing marketing rules under AIFMD and the UCITS Directive;
- the most important change results from the introduction of a new definition of "pre-marketing" which will be introduced for EU AIFMs, EuSEF and EuVECA managers. The original proposals entailed marketing being deemed to begin at a much earlier stage than at present (at least in the UK) which would be highly disruptive for private fundraisings. The Council's agreement allows certain draft fund marketing materials to be provided to potential investors at the pre-marketing stage. Such documents must be marked as 'draft' and state that they are subject to change. The Council's agreement also allows established AIFs which are not yet notified for marketing to conduct pre-marketing (the original proposals only allowed pre-marketing to be conducted by funds which are not yet established);
- where an EU AIFM or UCITS manager has exercised a marketing passport into another EU jurisdiction in relation to an EU AIF or UCITS fund and wishes to cease marketing, it will only be able to do so if the number of investors in the relevant jurisdiction does not exceed a specified minimum level and the manager offers to buy-out existing investors in that jurisdiction;
- where an EU or non-EU AIFM markets an AIF to retail investors in another EU Member State, it will be required to maintain facilities in that Member State to process payments with, and provide information to, investors. The existing UCITS requirements for paying agents will be aligned to these new AIFMD requirements;
- national regulators will be able to require AIFMs and UCITS managers to submit marketing communications to verify their compliance with the AIFMD or UCITS requirements; and
- the legislation confirms that host State regulators may levy fees and charges for authorisation or supervision under AIFMD or the UCITS directive, but only if these are proportionate.

Some parts of the Omnibus regulation could apply from mid-late 2019 at the earliest (assuming a streamlined legislative process), but the majority of the new rules (and the more significant changes, including the Omnibus directive) will be unlikely to apply until mid-late 2021 at the very earliest.

In terms of next steps, the proposals will continue to make their way through the legislative process. It has been reported that the European Commission is concerned that the Council's agreement does not include sufficient safeguards to avoid circumvention of the pre-marketing rules; a view which is not shared by the UK industry which have been supportive of the amendments proposed by the Council. In December 2018, the European Parliament's Economic and Monetary Affairs Committee ("**ECON**") published a press release stating that it has voted to adopt draft reports on the legislative proposals and put forward further proposed changes. ECON also recommended that ESMA be directed to produce guidelines on marketing communications.

Full details on the original proposals are available in our client briefing.

AIFMD report published by European Commission, further delays to AIFMD II

The provisions of the AIFMD provide for a comprehensive review of the entire directive to have commenced by the European Commission by July 2017. Whilst the results of the review are now not expected to be published until 2020, the European Commission has been proceeding with its preparatory work.

KPMG were engaged by the Commission in 2017 to prepare an impact report on the functioning of the

AIFMD. The report was published in January 2019 and is available here. The report covers the findings of both KPMG's general survey and evidence-based study. The report found that the AIFMD has played a major role in helping to create an internal market for AIFs and a harmonised and stringent regulatory and supervisory framework for AIFMs. Most areas of the provisions are assessed as having contributed to achievement of the specific and operational objectives, to have done so effectively, efficiently and coherently, to remain relevant and to have EU added value. There are, however, some provisions (or the detail or application of which) that have not contributed, or may be counter to, the achievement of these aims.

KPMG identified the following areas of potential weakness:

- ***Marketing passport and NPPR***: whilst evidence indicates that the EU management passport is working well, the EU marketing passport is lagging behind and is suffering from the different approaches taken by different national competent authorities ("**NCAs**"). Interviewees identified two main concerns: (i) a large divergence of marketing requirements between EU Member States due to the inconsistent application of the AIFMD marketing rules; and (ii) uncertainty over the application of the definition of marketing and pre-marketing (the report notes that the Omnibus proposals seeks to address these points). In relation to non-EU AIFs and AIFMs, developments vary markedly from one Member State to another. The report states that it is clearly of EU added value that NPPRs are permitted to continue to operate;

- ***Transparency and reporting:*** The reporting requirements are viewed as giving rise to unnecessary, duplicative or insufficient data reports, even more so when other reporting requirements are taken into account (e.g. under the European Market Infrastructure Regulation ("**EMIR**") and the Securities Financing Transaction Regulation ("**SFTR**"). Differences in national interpretation and filing procedures further exacerbate costs, which are not compensated for by the availability or regular provision of analysis to the market (and in particular, to investors) at national or EU level;

- ***Leverage:*** the report states that it is important to harmonise the calculation methodologies for leverage across the AIFMD, the UCITS Directive and other relevant legislation. In the light of IOSCO's work on common leverage measures, it would be more efficient if any changes to EU requirements are considered only after IOSCO's work is complete and introduced simultaneously for UCITS and AIFs;

- ***Valuation:*** the binary choice in the valuation rules between internal or external valuation, and the differing legal interpretations of the liability of external valuers, are assessed as having impaired the effectiveness of the rules for some asset classes and in some Member States. Given the differing legal interpretations, it is reported that there are fewer available external valuers in some Member States, which lowers the level of competition and could result in higher fees charged to AIFs/AIFMs;

- ***Depositary rules:*** some of the AIFMD depositary rules are interpreted differently in different Member States – for example, there are differing national approaches to the total look-through provision and to the cash monitoring duties, but it is not clear whether and to what extent this has impaired the effectiveness of the provisions;

- ***Investor disclosures***: there is a strength of opinion that the Article 23 AIFMD requirements on disclosures to investors are excessive in quantity and therefore are ignored or prevent investors from obtaining a clear understanding of the AIF's investment proposal. On the other hand, some representatives of institutional investors noted that there remain insufficient or non-standardised disclosures of all fees, costs and charges in e.g. private equity investment. The rules are inconsistent with other EU investor disclosure regimes and give rise to duplicative (and potentially inconsistent) disclosures;

- ***Investments in non-listed companies***: the report states that the requirements relating to investments in non-listed companies and enterprises came under particular criticism. The extent of the notifications to NCAs are not viewed as useful, essential and are overly burdensome, and it is not clear what use the NCAs can or do make of the information (bearing in mind that NCAs have powers to ask for data on an ad hoc basis). Further, the AIFMD is not regarded as having improved the information provided by the AIF/AIFM to controlled companies or as having had a positive impact on the relationship between AIFs/AIFMs and target or investee enterprises. There is a lack of clarity in relation to the meaning of "non-listed company" and the application of the rules to investments in unlisted special purpose investment vehicle and unlisted UCITS or AIFs;

- ***Risk and portfolio management***: there was a differentiated response, in particular from the private equity and real estate sectors, about the necessity of full functional and hierarchical separation of risk and portfolio management and the impact on smaller AIFMs. However, the report states that the onus is on NCAs to ensure appropriate application of the proportionality principle in such cases;

- ***Remuneration***: there are questions about the coherence of the AIFMD remuneration rules with other pieces of legislation and guidelines (especially for AIFMs that are part of corporate groups with interfaces to more than one regulatory regime), which in turn reduces the potential efficiency of the regime.

The European Commission intends to launch a public consultation on the entire AIFMD, the results of which will, together with KPMG's report, form the basis of the review. In terms of timing, the Commission's press release accompanying the report states that it will continue its review of the AIFMD and next year will report to the European Parliament and the Council on the functioning of the AIFMD. Of course, there are various other initiatives being worked on at a European level which will impact on the provisions of the AIFMD, most notably the Omnibus directive and the Omnibus regulation.

MISCELLANEOUS UPDATES

IOSCO consults on framework for assessing leverage in investment funds

In November 2018, the International Organization of Securities Commissions ("**IOSCO**") published a consultation on a proposed framework to help assess leverage used by investment funds.

The proposed framework comprises a two-step process aimed at achieving a meaningful and consistent assessment of global leverage. The first step indicates how regulators could exclude from consideration funds that are unlikely to create stability risks to the financial system while filtering and selecting a subset of other funds for further analysis.

The second step calls for regulators to conduct a risk-based analysis of the subset of investment funds identified in the first step. The consultation paper principally focuses on the first step, although it also invites feedback on both the second step and the design of the two-step approach.

IOSCO does not prescribe a particular set of metrics or other analytical tools. Instead, each jurisdiction is expected to determine which is the most appropriate risk assessment for it to adopt, given that some risk-based measures are not appropriate for all funds.

The consultation closes in **February 2019**.

EFAMA revises asset management stewardship code

The European Fund and Asset Management Association ("**EFAMA**") has published an updated stewardship code, first published in 2011, which aims to encourage best practice among asset manager members on issues such as ESG and human rights in the companies they invest in.

The code has been updated following the adoption of the revision of the Shareholder Rights Directive. It introduces an obligation for asset managers and asset owners to disclose a shareholder engagement policy and report on its implementation, or explain why they have not complied with these requirements.

FCA consultation and discussion papers on patient capital

In December 2018, the FCA published a consultation paper and a discussion paper in relation to patient capital and which form part of the FCA's response to HM Treasury's Patient Capital Review, launched in 2016.

The consultation paper proposes changes to permitted links rules to facilitate investment in patient capital (such as infrastructure, real estate, private equity, debt and venture capital). The aim is that the proposals will lead to greater investment in patient capital via unit-linked funds where such investments are appropriate and suitable for retail investors and their investment goals. The proposals include a new 'patient capital' class of authorised unit-linked investment funds permitted to hold up to 50% of assets in illiquid, long-term holdings.

The discussion paper explores how effectively the UK's existing fund regime enables investment in patient capital. The FCA is seeking views on whether:

- the regime provides investors and fund managers with appropriate access to patient capital investments while maintaining the right level of consumer protection;
- the current limits on investments in patient capital for some types of fund are appropriate;
- the relevant rules should be amended to make it easier to make direct investments in infrastructure projects; and
- there is demand for a new type of authorised retail fund which can invest all its capital directly into patient capital assets.

The deadline for comments is **28 February 2019**. The FCA will publish a feedback statement and next steps in 2019.

White Paper consultation on national security and infrastructure investment review

In July 2018, BEIS published a White Paper consultation seeking views on proposed new powers for the Government to intervene in transactions on grounds of national security. The Government aims to "protect national security from hostile actors using ownership of, or influence over, businesses and assets to harm the country".

Similar to the current UK merger control regime, the White Paper sets out a voluntary notification system. Businesses and investors will be encouraged to notify the Government in advance of any relevant transactions or events which may give rise to national security concerns. However, regardless of whether a transaction has been notified, the Government proposes a wide power to "call-in" any transactions or other events which it believes raises national security concerns (either before completion or post-completion for a proposed specified period of 6 months).

There will be no turnover or market share thresholds below which transactions fall outside the remit of the new regime, but the White Paper proposes certain trigger events which will enable the Government to review a deal, including investment or activity involving the direct or indirect acquisition of:

- more than 25% of any entity's shares or votes;
- significant influence or control over an entity; and
- further acquisitions of significant influence or control over an entity beyond the above thresholds, including the acquisition of over 50% or 75% of shares/votes, or new or additional rights such as board appointment rights (effectively, the Government will be able to intervene where future acquisition/control thresholds are met even where it decided not to call-in a transaction following an initial trigger event).

The consultation closed in October and the Government will use responses to the White Paper to refine the proposals ahead of introduction of primary legislation.

The proposals are in line with steps taken around the world by other countries to protect national security interests.

For example, recent steps have been taken in the US to expand the powers of the Committee on Foreign Investment ("**CFIUS**") regime. The new pilot programme, for 'critical technologies', came into effect in November 2018 (but it exempts any transaction for which a definitive agreement was signed before 11 October 2018). The new CFIUS rules apply to investments in a US entity by a non-US venture capital or private equity fund in a 'pilot program U.S. Business' and, where applicable, require mandatory US filings.

Similarly, in October 2017 the European Commission published a proposal to establish a framework for screening foreign direct investments ("**FDIs**") into the European Union. The proposal has been making its way through the legislative process, with the European Parliament's endorsement being sought at a plenary session in February 2019. Elsewhere in the EU, France has proposed a similar regime to the UK and Germany has already brought into effect its national screening legislation. Outside the EU, Australia, Canada and Japan already have well established screening mechanisms.

The Government itself has acknowledged that the proposals amount to a "significant expansion in its powers", as they potentially capture transactions regardless of the parties' revenues or market share, and in any sector. In the US, for example, the CFIUS regime has been used to block several transactions involving Chinese buyers. Whilst such cases of outright prohibition are relatively rare, there is some evidence that the expanded powers of the US government have led to an increase in the number of transactions being abandoned in the face of security concerns. Even if this experience is not replicated in the UK, it seems almost inevitable that more transactions will face the additional procedural hurdle of addressing national security concerns, which is likely to have material implications for timing and costs.

Investment Association publishes guidance on marketing financial products and services to UK LGPS clients

In May 2018, the Investment Association ("**IA**") published guidance on marketing financial products and services to UK local government pension scheme ("**LGPS**") clients. The guidance covers:

- communicating with LGPS clients prior to opting-up to professional client status, including the implications of whether a communication is a financial promotion or not;
- practical application when a firm is hosting a conference, or similar events, including whether LGPS clients can attend if they have not been opted-up and what type of products can be talked about; and
- communicating with LGPS funds as part of a pool.

Electronic execution of documents: Law Commission consultation

In August 2018 the Law Commission published a consultation paper on the electronic execution of documents. It has been investigating the reasons why electronic signatures are not being more widely used, and to address any legal uncertainties in order to ensure that the law is sufficiently certain and flexible. The project focuses on:

- the use of electronic signatures to execute documents where there is a statutory requirement that a document must be "signed"; and
- the electronic execution of deeds, including the requirements of witnessing, attestation and delivery.

The Law Commission is not persuaded of the need for a legislative statement confirming the validity of electronic signatures. Instead, it suggests that stakeholders may wish to bring a test case to seek an authoritative ruling on the use of electronic signatures in particular circumstances. It also provisionally proposes that a government-backed industry working group should provide guidance on best practice.

The consultation ended in November 2018. The Law Commission plans to publish a subsequent report setting out its final recommendations, which will be formulated in light of the responses to the consultation.

For further information about the issues discussed in this briefing, please contact one of the partners in our Investment Funds group, or your usual contact at Travers Smith.

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