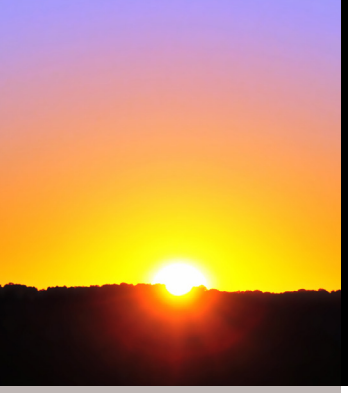

Newsletter

BURGES SALMON

Authorised Fund Horizons

Autumn 2015

Welcome

Welcome to the very first edition of Authorised Fund Horizons, a practical guide to legal and regulatory developments in the UK authorised funds sector from Burges Salmon's Funds and Financial Regulation team.

This Autumn edition looks at recent developments on the Senior Managers and Certification Regime, UCITS V, the Common Reporting Standards, EMIR, the ELTIF Regulation, CAIFs and miscellaneous changes to fund regulation.

For further information on our Funds and Financial Regulation team and the services we offer, please use the contact details on the back page.

To receive your own copy of Authorised Fund Horizons, please send your details to marketing@burges-salmon.com

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Senior Managers & Certification Regime

On 15 October HM Treasury confirmed in a policy paper that the Senior Managers and Certification Regime (SM&CR) will be extended under the Bank of England and Financial Services Bill beyond the banking sector to all sectors of the financial services industry, thereby replacing the "discredited" approved persons regime. This is a topic we will be following closely and we will be providing further briefings as developments occur.

The policy paper confirms that the key features of the new regime will be as follows:

- An approval regime focussed on senior management, with requirements on firms to submit robust documentation on the scope of these individuals' responsibilities. The new Senior Managers Regime will apply to a narrower range of individuals within a firm in order to focus accountability on a smaller number of senior personnel.
- A statutory requirement for senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility.
- A licensing regime (which will be known as the Certification Regime) will apply to individuals not covered by the Senior Managers Regime but whose actions could **significantly** harm the firm, its reputation or its customers. These individuals will not undergo a regulatory approval process. Instead firms are required to act as "mini-regulators" and will be responsible for assessing and certifying the fitness and propriety of employees covered by the regime.
- The existing Statements of Principle and Code of Practice for Approved Persons (APER) will be replaced by an enforceable set of conduct rules applying to a much wider range of staff. If these are breached the FCA will be able to take action against individuals personally.

It seems that certain aspects of the regime that would have applied to the banking sector have been abandoned altogether or watered down in this context. In particular, the statutory requirement outlined at the second bullet point above supersedes the *"reverse burden of proof"* in the SM&CR proposals for the banking sector where there would have been a presumption that a senior manager at a bank had committed misconduct if the firm breached a requirement in an area for which the manager was responsible. It is also unclear whether the proposed criminal offence of being involved in a reckless decision that causes a firm to fail will be extended to other sections of the industry beyond the banking sector.

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How will the changes affect my firm?

According to the policy paper the main effects for firms are likely to be:

- A substantial reduction in the number of appointments that are subject to prior regulatory approval, although there may be increased costs per application as firms prepare the documents required under the new regime including 'statements of responsibility' and other required information.
- Most current approved persons below senior management level are expected to become certified persons. Some roles in firms where regulatory approval is not currently required may also become certified person roles. There will be some costs for firms in complying with certification requirements but the paper does not anticipate these will be large.
- Firms may incur some additional costs from putting in place systems to ensure employees are notified about, and receive suitable training in, the rules of conduct that will apply to them.

When is this happening?

Whereas the banking SM&CR will come into force on 7 March 2016, the government intends to implement the extended SM&CR (as outlined above) during 2018.

*Please send any queries to **Victor Ondoro** or **James Green** in the first instance.*

UCITS V – an update

Background

EU member states have until 18 March 2016 to implement the UCITS V Directive, which will result in significant changes to the UCITS requirements around depositaries, remuneration and sanctions.

What's new?

The most noteworthy recent developments have been the launch of two consultations. The first was launched by ESMA in July in respect of the Level 3 remuneration guidelines with responses due by 23 October and publication of the final guidelines in Q1 2016. The second was the FCA's CP 15/27, part 1 of which focuses on proposed changes to the FCA Handbook to implement the Directive. In this consultation the FCA proposes to implement the Directive through an 'intelligent copy-out' approach (i.e. by transposing the wording of UCITS V into the Handbook and seeking not to go beyond these wherever possible). Responses to the FCA consultation are due by 9 November.

Another key development will be the publication of the Level 2 measures which has been delayed but is expected imminently. As with AIFMD, it is anticipated that this will take the form of an EU regulation which will be directly applicable in member states without the need for further implementation (although as with AIFMD the FCA will no doubt make further changes to its Handbook to cross refer to the Level 2 provisions).

HM Treasury will also be launching a separate consultation in due course in respect of proposed changes to UK primary and secondary legislation (as distinct from the FCA Handbook).

What do I need to do?

As a result of the proposed changes to the UCITS regime there are a number of actions that will need to be taken by UCITS ManCos including:

1. Updating depositary agreements (or trust deeds in the case of authorised unit trusts) in line with the Level 2 measures once these are published - it is likely the required changes will be broadly similar to those under AIFMD.

2. Considering the application of the UCITS V remuneration requirements. The FCA is proposing to implement the requirements in a new remuneration code for UCITS ManCos at SYSC 19E of the FCA Handbook. The proposed code is substantially similar to the AIFMD code at SYSC 19B. UCITS managers who are also full-scope AIFMs will be subject to both codes and need to produce policies to explain how staff subject to both codes are remunerated. Managers will need to comply with the remuneration principles for new awards of variable remuneration from the first full performance period starting on or after 18 March 2016.

3. Updating the fund prospectus to disclose additional information, including:

   - a description of potential conflicts of interest between the manager, the UCITS, the UCITS investors and the depositary;
   - an outline of any dedicated safe-keeping functions, including a full list of custodians and sub-custodians and any potential conflicts of interest relating to them;
   - details of the manager's remuneration policy (or otherwise this can be given on the website and signposted in the KIID); and
   - certain additional details regarding the depositary.

It is anticipated that transitional provisions will apply potentially to allow managers until 18 September 2016 to update the prospectus, with KIID changes to be made prior to the next annual update following the implementation date of 18 March 2016.

4. Details of the UCITS' remuneration practices, including the remuneration paid by the manager to its staff, will have to be disclosed in the fund's annual report.

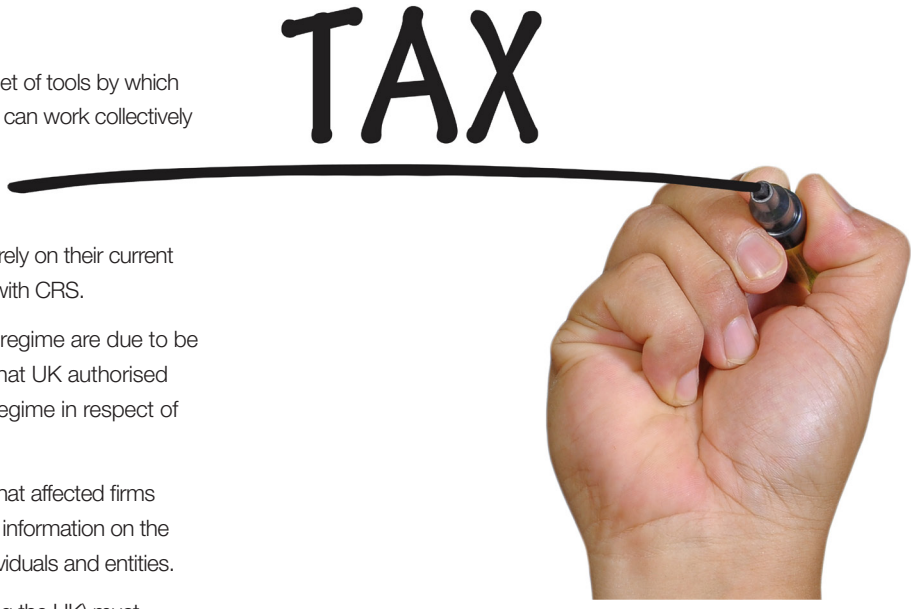
5. UCITS V also brings in whistleblowing requirements. ManCos and depositaries will be required to adopt processes for employees to make internal reports on any potential or actual breaches of the UCITS rules.

We will provide a further progress update in the next edition of this briefing.

*Please direct any queries to **Victor Ondoro** or **Ursula McGuigan** in the first instance.*

Common Reporting Standards – an introduction

In a nutshell



The Common Reporting Standards (CRS) are a set of tools by which governments (and their respective tax authorities) can work collectively to share information in order to recover additional taxation revenues. Based under the same initiative that effected FATCA, the CRS regime is much broader and firms cannot simply rely on their current FATCA reporting systems to ensure compliance with CRS.

The first information exchanges under the CRS regime are due to be made in September 2017 and it is anticipated that UK authorised fund managers will generally be caught by the regime in respect of the funds they manage.

The CRS contain detailed rules and procedures that affected firms must follow to ensure that they collect and report information on the financial assets they hold on behalf of certain individuals and entities.

Funds based in participating jurisdictions (including the UK) must review their existing accounts and the accounts their investors are looking to open with them to see whether they are reportable. An account will be reportable if: (1) the applicant account holder is resident for tax purposes in a jurisdiction covered by the CRS; and (2) they are a reportable person. Although there are specific exclusions (for example covering central banks) most entities are reportable persons. There are also rules which determine when the legal structure of an account holder that would otherwise not be a reportable person should be "looked through" and a report made on the basis of the reportable persons who ultimately own the account holder.

If a firm holds reportable accounts it must carry out a due diligence process and then report the relevant information to the tax authorities. There are different due diligence rules to be applied to accounts held by individuals and entities as well as for pre-existing and new accounts, reflecting the differing characteristics between different types of accounts.

Any individual who opens an account needs to provide self-certification which establishes where the individual is resident for tax purposes. If the self-certification establishes that they are resident for tax purposes in a reportable jurisdiction, then the fund must treat the account as a reportable.

Once the fund has obtained a self-certification it must confirm its reasonableness based on the information obtained in connection with the opening of the account, including any documentation collected pursuant to AML/KYC procedures. The fund then has to report information on the identity of the account holder, the account, the fund itself, where the account is held and the activity taking place in the account and its balance.

*We are able to provide specific advice on the implementation of CRS within your business. Please send your queries to **Ian Carnochan** or **Gareth Malna** in the first instance.*

EMIR

A brief recap

The EMIR Regulation on OTC derivatives, central counterparties and trade repositories imposes regulatory requirements on the use of derivatives, in particular so called "over-the-counter" (OTC) derivatives entered into outside regulated markets. Despite coming into force on 16 August 2012 it continues to be implemented piecemeal through the publication of technical standards with many of the "non-financial" requirements around reporting and risk-mitigation already in force.

The requirements apply in full to "financial counterparties" which includes UCITS and their ManCos and an AIFM managing an AIF (in each case where the fund uses derivatives as part of its investment strategy).

Since 12 February 2014 there has been an obligation to report all derivatives trades (exchange traded as well as OTC) to a regulated trade repository. In addition, OTC derivative trades which are not centrally cleared are subject to further administrative requirements around timely confirmation of transactions, portfolio reconciliation and (where applicable) compression, dispute resolution and daily valuation of transactions.

What's new?

A cornerstone of the EMIR legislation (and Dodd-Frank, its equivalent in the US) is the requirement for standardised OTC derivatives to be cleared through central counterparties (CCPs). These requirements are not yet in force, however, it is anticipated that the first clearing obligations for certain interest rate derivatives may be in place from April 2016 with other types of standardised derivative to follow.

It is also expected that variation margin requirements for non-cleared OTC derivative trades will be in place for major market participants from October 2016, and that such requirements will be phased in for all other counterparties during Q1 of 2017. Initial margin requirements are likely to be brought in through a phased approach over the course of four years from September 2016.

What should I be doing?

If you are an authorised fund manager for funds that use derivatives you should be complying with the EMIR provisions that are already in force. Where funds use OTC derivatives that are likely in due course to be subject to clearing requirements you should be looking to establish contractual arrangements with CCPs and/or clearing members to enable you to comply. Where investment management is delegated to a third party you should make sure you (and they) are clear on the extent to which they taking responsibility for ensuring that you comply with EMIR and this should be reflected in the IMA.

Anything else I should be aware of?

We note the opinion published by ESMA in May 2015 in which it stated that the UCITS Directive should no longer distinguish between OTC derivatives and exchange traded derivatives (ETDs) in the context of the spread requirements. Instead the distinction should be between cleared and un-cleared derivatives as the counterparty risk is potentially similar as between an ETD and a cleared OTC derivative, although additional analysis is required regarding the nature of the clearing arrangements. By way of example, in ESMA's view a trade cleared directly with a CCP is effectively equivalent to an ETD but where a trade is cleared through a CCP clearing member there is greater potential for risk and delay (in particular some CCPs may require individual client segregation, whilst others use omnibus client segregation where risk is higher).

Interestingly ESMA also noted a potential conflict between the UCITS Directive (which effectively requires the inclusion in derivative contracts of a unilateral termination right for UCITS) and EMIR which envisages the mandatory clearing of certain OTC derivatives but does not provide ESMA with any authority to compel CCPs to accept such a unilateral termination right.

More recently, a letter sent from ESMA to the European Commission on 2 October has made it clear that ESMA intends to consult on making amendments to the regulatory technical standards on the indirect clearing of OTC derivatives. This is to take account of issues raised in a distinct ESMA consultation into the draft technical standards surrounding the indirect clearing of ETDs under the MiFIR requirements.

*Please send your queries to **Tom Dunn** in the first instance.*

MiFID II - execution-only services

MiFID II is an enormously wide-ranging piece of legislation that will result in significant changes to many aspects of the financial services industry when implemented in January 2017.

UCITS ManCos and AIFMs are not directly within scope but should not overlook its potential impact on them and their distribution models. In particular, all NURS funds and structured UCITS will fall within the revised definition of a "complex product" under MiFID II. This means it will no longer be possible for investment firms to sell such funds on an execution-only basis without carrying out some form of appropriateness test to ascertain a potential investor's knowledge and experience.

Industry figures have raised concerns that this may lead to firms looting to convert their NURS funds to UCITS which could lead to adverse consumer outcomes due to reduced investment flexibility and the potential need to restructure portfolios to meet asset allocation requirements. We understand the Investment Association is seeking to work with the FCA to try to design an appropriateness regime that is aligned to the actual consumer risk involved. We will continue to keep you updated on developments.

Implementation Update

On 28 September ESMA published its final report on draft ITS and RTS under MiFID II. This has been submitted to the European Commission for endorsement, who have three months to make a decision on the endorsement. We will provide a full update on the Commission's response in our next briefing.

Please send your queries to **Adrian Shedden** *in the first instance.*

Other changes to fund regulation

In addition to UCITS V (outlined above) the FCA's CP 15/27 also consults on a number of other changes to the FCA Handbook around the regulation of authorised funds including the following:

1. **The ELTIF Regulation**
   European Long Term Investment Funds (ELTIFs) are a new type of closed-ended fund that will invest in assets with a long-term horizon. The driving motivations for creating the ELTIF framework have been the creation of a single market in the EU for a long-term investment fund and the provision of long-term financing to EU companies and projects. UK domiciled ELTIFs will need to be authorised by the FCA and will operate under the AIFMD regime. AIFMD-authorised managers of ELTIFs may be able to market their ELTIF to retail investors provided they meet certain additional requirements.

   The ELTIF Regulation will come into force in the UK from 9 December 2015 and is directly applicable under EU law without the need for implementation by the FCA. However, in Part II of CP 15/27 the FCA has consulted on proposed adaptations to the FCA Handbook so that the ELTIF Regulation can function properly in the UK, including the introduction of a new section of the Investment Funds sourcebook (FUND) called "European AIF Regimes" to include rules and guidance relating to ELTIFs. The deadline for responses to this part of the CP was 5 October in order to allow the FCA to put the required rules and guidance in place by 9 December.

2. **Miscellaneous changes to fund regulation**
   In Part III of CP 15/27 the FCA has outlined a number of proposed additional changes to rules and guidance in the FCA Handbook relating to authorised funds including:

   - *Reporting by UCITS AFMs*
     An AFM of a UCITS scheme is currently required to notify details of its derivative risk management process (DRMP)

to the FCA on a regular basis (and at least annually) but the format for submitting this information is not currently defined. The FCA therefore proposes to introduce a standard DRMP reporting template to assist AFMs to submit complete and comparable information. AFMs will have to submit an annual report via the GABRIEL system on the last business day of November each year, containing the information on the DRMP as of 15 October of the same year.

- *Reporting by depositaries*
  The FCA is looking to introduce enhanced requirements for depositaries to report information on breaches by the AFMs they oversee. Under the new proposals, all breaches of COLL/FUND will need to be reported to the FCA by a fund's depositary, together with a declaration as to whether the depositary considers the AFM's controls over valuation and pricing and box management to be adequate. The FCA has also said it may consider publishing summary information in future (for example, total number of breaches reported, numbers by breach type, etc.) if stakeholders would find it useful.

- *Identifying funds in customer documents*
  The FCA uses Product Reference Numbers (PRNs) to identify each fund that it authorises – and is currently working to assign a PRN to each sub-fund of an umbrella scheme to make it easier for stakeholders to find out the regulatory status of a fund. In CP 15/27 the FCA has proposed to amend COLL 4.2.5R and COLL 8.3.4R (outlining the required contents of an authorised fund's prospectus) to require the prospectus to include the fund's PRN or, for an umbrella, the PRN of each relevant sub-fund. A transitional provision will apply so this can be done when the prospectus is next updated for other purposes.

- *Charity authorised investment funds*
  In the March 2015 budget it was announced that the FCA would be working with the Treasury and the Charity Commission to enable AIFMs to launch a new type of authorised fund which will be registered as a charity under the Charities Act. These funds will be called Charity Authorised Investment Funds (CAIFs) and will be authorised funds which are, therefore, regulated by the FCA – but also registered as a charity under Part 4 of the Charities Act 2011 and regulated as such by the Charity Commission. In CP15/27 the FCA has proposed a number of changes to COLL to introduce the concept of a CAIF including a new section in COLL (COLL 14) setting out specific rules and guidance applicable to the manager and depositary of a CAIF.

- *Investing in government and public securities*
  The FCA is proposing to amend certain COLL rules to correct a mismatch between the investment powers allowed by the UCITS Directive and the standard definition of GaPS in the Glossary to the FCA Handbook. The Glossary definition allows a UCITS scheme to invest more than 35% in value of its scheme property in securities issued or guaranteed by a local authority in any state, whereas the Directive allows only local authorities of an EEA State to be the issuers or guarantors. As such, a UCITS scheme which has invested more than 35% in value of its scheme property in securities issued or guaranteed by a single non-EEA local authority may be inadvertently breaching the diversification limits in the Directive. The FCA intends to correct this issue by removing references to the Glossary-defined term 'government and public securities' and replacing them with a fuller description of the categories of issuer or guarantor permitted by the Directive. The FCA proposes to extend the same provision to NURS for the benefit of consistency between UCITS and NURS rules on this point. As such UCITS and NURS managers should consider their exposure to non-EEA issued or guaranteed securities and assess whether they may be at risk of breaching the updated diversification requirements in COLL.

- *"Soft closures"*
  Although it is not currently proposing new rules or guidance the FCA is also asking for views on whether it should modify COLL 6.2.18R, which covers the circumstances in which AFMs may limit the issue of units without curtaining unitholders' ability to sell their units (so called soft closing). At present the introduction of soft closing arrangements requires the AFM to amend the prospectus which (in the case of an OEIC) requires prior approval from the FCA. The FCA has been asked to look at allowing more flexibility to introduce such arrangements at short notice where, for example, it would be detrimental to existing investors to allow additional inflows due to a lack of investment opportunities in the context of the fund's investment strategy. The FCA is keen to understand the practical benefits and risks for firms and investors of modifying the relevant rules and what specific changes might strike an appropriate balance.

Firms are invited to submit responses to Part III of CP 15/27 by ***7 December 2015.***

If any of the information above is of interest please contact one of our dedicated experts:

Funds and Financial Regulation team

Chris Godfrey
Partner
T: +44 (0) 117 939 2219
E: chris.godfrey@burges-salmon.com

Tom Dunn
Partner
T: +44 (0) 117 902 7796
E: tom.dunn@burges-salmon.com

Victor Ondoro
Consultant
T: +44 (0) 117 307 6051
E: victor.ondoro@burges-salmon.com

Ian Carnochan
Senior Associate
T: +44 (0) 117 307 6054
E: ian.carnochan@burges-salmon.com

James Green
Senior Associate
T: +44 (0) 117 939 2252
E: james.green@burges-salmon.com

Adrian Shedden
Associate
T: +44 (0) 117 307 6813
E: adrian.shedden@burges-salmon.com

Ursula McGuigan
Solicitor
T: +44 (0) 117 307 6061
E: ursula.mcguigan@burges-salmon.com

Gareth Malna
Solicitor
T: +44 (0) 117 902 2799
E: gareth.malna@burges-salmon.com

Visit our website at www.burges-salmon.com

One Glass Wharf
Bristol BS2 0ZX
Tel: +44 (0) 117 939 2000
Fax: +44 (0) 117 902 4400

6 New Street Square
London EC4A 3BF
Tel: +44 (0) 20 7685 1200
Fax: +44 (0) 20 7980 4966

www.burges-salmon.com

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