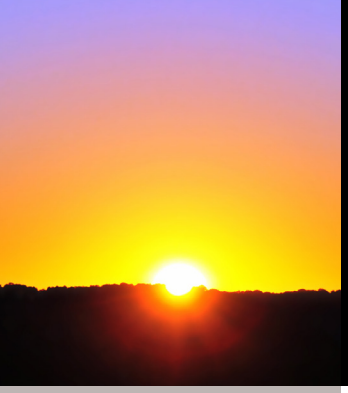

Newsletter

Authorised Fund Horizons

BURGES SALMON

Spring 2016

Welcome

Welcome to the Spring 2016 edition of Authorised Fund Horizons, our practical guide to legal and regulatory developments in the UK authorised funds sector from Burges Salmon's Funds and Financial Regulation team.

In this edition we open with an article on Brexit as the discussions heat up ahead of the June referendum. We also look at other topics including UCITS V, MiFID II and the FCA's thematic review on meeting investors' expectations. Finally, Arendt & Medernach provide an overview of hot topics and market trends in Luxembourg.

For further information on our Funds and Financial Regulation team and the services we offer, please see 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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Brexit – too uncertain to call...

It is not clear at the time of writing what the world will look like for UK fund managers when we publish our next edition of Authorised Fund Horizons in August. However, what *is* clear is that if the UK votes in favour of leaving the EU on 23 June then the terms on which the UK's withdrawal is agreed will be of paramount importance. Until then it is really only possible to speculate on the consequences of a potential Brexit. However, we have set out in this note some key areas of potential impact for fund managers.

Passporting rights

This is undoubtedly the biggest issue in a fund management and marketing context - in particular for managers of UK UCITS funds who would lose the ability to market such funds into EU jurisdictions under the UCITS product passport. Under the UCITS Directive a UCITS must be authorised in an EU member state so, in the event of an exit, it is likely that a UK "UCITS" would be reclassified as a form of alternative investment fund. This could potentially have consequences that may not be initially apparent, for example, breaches of investment restrictions which require fund managers only to invest a specified maximum in non-UCITS collective investment schemes. There may also be the possibility of redemptions by certain classes of investors for whom the UCITS "brand" is important in the context of their investment strategy.

More widely, any UK firm that relies on a passport to conduct its business will be impacted. This will also affect non-EEA businesses whose strategy has involved setting up an authorised UK subsidiary as a gateway to access the European market (which may in part be one of the reasons why the US president has been imploring the UK to vote against an exit).

Of course, this would also go the other way too with EU managers potentially unable to access the UK market, which would undoubtedly be a major factor in the UK's favour in negotiating any exit terms given the size of the UK financial services industry.

Post-Brexit access to Europe

As has been widely reported, the withdrawal of a member state is unprecedented so we can only speculate as to what the terms of such an exit would be based on existing models such as Norway and Switzerland. The key issues would of course be the

extent to which the UK would be able to access the European market (and vice versa), the conditions for doing so (in particular whether there would be requirements for the UK to put in place equivalent legislation) and the extent to which the UK would be able to influence any legislation to which it would effectively be subject under an equivalence regime. Clearly these points will potentially be of less relevance for fund management businesses which do not have EU-wide operations or marketing strategies.

Inevitably there would also be a period of uncertainty while the terms of the exit were negotiated and it is likely such uncertainty would in itself be problematic for many fund managers.

What should fund managers be doing now?

With so much uncertainty it is tempting for firms to do nothing until the result is known. However, one practical step that can be taken is to review your existing contracts to see how these might be affected by leaving the EU, in particular given that counterparties may seek to reassess their current arrangements, business models and contractual commitments in such circumstances.

If you have any questions regarding the potential impact of a Brexit on your business or in respect of your existing contractual arrangements please feel free to speak to your usual Burges Salmon lawyer or send your query to ***Tom Dunn*** *or* ***Gareth Malna*** *in the first instance.*

UCITS V developments

Since our Winter edition there have been a number of developments in relation to UCITS V, most notably the publication of the final Level 2 Regulation and ESMA Remuneration guidelines respectively.

Level 2 Regulation

On 24 March 2016 the UCITS V Level 2 Regulation was published in the Official Journal of the EU. The Level 2 Regulation entered into force on 12 April 2016 (20 days following its publication in the OJ) and will apply from 13 October 2016. We can confirm there are no changes from the official draft published on 17 December 2015 and which was described in our previous edition.

ESMA Remuneration guidelines

On 31 March 2016 the European Securities and Markets Authority (ESMA) published its final guidelines on sound remuneration policies under UCITS Directive and AIFMD which will apply from 1 January 2017.

What's new?

The final guidelines take a different position to that indicated in the draft guidelines published last summer. In the draft guidelines, ESMA had indicated that certain smaller or less complex firms should be permitted to conclude that it would not be proportionate for them to apply the "Pay Out Process Rules" (the rules requiring deferral of up to 60% of variable remuneration, the payment of 50% of variable remuneration in fund units and the operation of malus provisions). This also reflects the position under the AIFMD remuneration guidelines.

However, in the final guidelines, ESMA decided to follow the approach adopted by the European Banking Authority ("EBA") and did not include any guidance on whether disapplication of certain of the remuneration requirements in the UCITS Directive is permissible on the grounds of proportionality.

ESMA call for further clarity

In conjunction with the final UCITS Remuneration Guidelines, ESMA has written a letter to the European Commission, Parliament and Council setting out that in its view the language in the UCITS Directive makes it clear that proportionality may under certain circumstances result in the Pay Out Process Rules not being applied (or being applied by reference to lower thresholds) and stating that further legal clarity on this possibility (by way of legislative changes) could be beneficial to market participants, investors and regulators.

ESMA also highlighted that there may be cases where the application of the Pay Out Process Rules to a delegate of a UCITS management company would not be proportionate and may prevent access to certain investment strategies if non-EEA delegates are unwilling to be subject to requirements they consider to be disproportionate.

What is the FCA's position?

The FCA published its rules on the implementation of the UCITS remuneration rules on 2 February 2016 in its policy statement PS16/2, including draft guidance specifically providing for the disapplication of certain UCITS remuneration principles on the grounds of proportionality. In PS 16/2, the FCA stated that once the EMSA guidelines are finalised, the FCA may consider giving further guidance on the application of proportionality in the context of the UCITS remuneration code – and it is now very likely that such further guidance will be necessary.

What does the industry think?

ESMA stated in its final guidance that the overwhelming majority of respondents to its earlier consultation supported ESMA's position that disapplication on the grounds of proportionality should be permitted.

The Investment Association ("IA") has also published a circular stating that it considers: the FCA implementation of the UCITS remuneration code as set out in PS 16/2 is compliant with ESMA guidelines; the EBA interpretation of the principle of proportionality is based on a flawed interpretation of CRD IV; and there is no need to amend CRD IV, AIFMD or UCITS.

What should firms be doing?

Firms are required to implement a UCITS V compliant policy by the start of their next performance period. The big question is clearly how smaller and less complex firms should approach the proportionality principle in this regard. Following the final ESMA guidance it is anticipated that the FCA is likely to publish specific guidance on when it may be appropriate for UCITS management companies to disapply the Pay Out Process Rules on the basis of the proportionality principle. As such firms should review the further guidance once published and we will of course continue to keep you updated on developments.

*If you would like to discuss the steps your firm should be taking to comply with the UCITS V remuneration requirements please send your queries to **Victor Ondoro** in the first instance.*

Are you meeting expectations?

The FCA spotlight recently focused on fund managers as it carried out its thematic review on meeting investors' expectations, the results of which were published on 7 April 2016. As part of the review the FCA looked at 19 fund management firms responsible for 23 UCITS funds. The purpose was to ensure funds are being managed in accordance with their product descriptions and see whether they are being appropriately distributed. The review includes examples of good and poor practice and is something fund managers should be aware of and consider by reference to their own fund operations. The FCA's key findings were in relation to the following areas:

- **Clarity of product descriptions**
  The FCA commended the firms in its sample for generally providing adequate information about the funds' strategies, characteristics and inherent rules. However, it also highlighted the following instances of poor practice:
  - Five examples of "closet tracker" funds where the passive strategy had not been adequately disclosed to investors to allow them to judge risks and cost;
  - Some descriptions given by some Key Investor Information Documents (KIIDs) did not match how the relevant funds were managed – for example, firms had failed to disclose the use of benchmarks or exposure to currency risks.
- **Oversight and Governance**
  The FCA found that where funds were no longer being actively marketed to investors there appeared to be a concentration of issues suggesting that the firms had not overseen them as carefully as funds that were still being actively marketed – as the sample included four funds that were not being actively marketed and the FCA identified issues in all of them.
- **Ensuring appropriate distribution**
  The review reminds firms of the need to ensure appropriate distribution channels are being used and cites two funds available on execution-only platforms where the funds were only meant to be available with advice. The FCA indicates that fund managers should:
  - Obtain sufficient information from distributors to allow them to monitor and see that products are being appropriately distributed; and
  - Review and monitor sales patterns against the fund's target markets and identify unusual patterns potentially indicating distribution problems resulting in inappropriate sales.

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

MiFID II and NURS to UCITS conversions

A brief update on the state of MiFID II

The European Parliament confirmed on 7 April that the implementation of MiFID II will be delayed by one year to 3 January 2018, with Member State transposition required by mid-2017.

Complex products under MiFID II

As reported in our previous newsletter under current MiFID II proposals non-UCITS products including NURS funds, investment trusts and other multi-asset funds would be designated as "complex" meaning firms would need to carry out an appropriateness assessment to understand a potential investor's knowledge and experience prior to investment. This would effectively mean such funds could not be sold on an execution-only basis.

Hopes remain that the rules will be relaxed or modified to produce a narrower scope of complex investments for the purpose of the appropriateness test or otherwise a more qualitative test by reference to criteria such as the number of holdings, the actual risk to the consumer involved and/or whether there are frequent opportunities to dispose of, redeem or otherwise realise the instrument at prices publically available to market participation.

However, in the meantime some fund manager groups are taking no chances and looking to convert their NURS funds into UCITS vehicles so as not to jeopardise their existing retail distribution model. We have therefore set out below some issues to be considered if you are seeking to carry out any such conversion.

- ***What is the existing investment strategy of the NURS? Is it compatible with the UCITS regime?***
  Broadly, a NURS has wider investment powers than a UCITS, including the power to invest directly in property, gold and/or unregulated collective investment schemes. If these powers are currently utilised then they will need to be modified accordingly.

- ***How will the conversion be implemented?***
  In particular, will the conversion take place within the existing fund structure or will the NURS be merged with an existing UCITS via a scheme of arrangement? The steps involved are quite different between these two options so this will need to be determined at an early stage by the fund manager in conjunction with the depository and other relevant parties.

- ***Is FCA approval required?***
  A NURS to UCITS conversion (whether effected within the same structure or by way of a scheme of arrangement) will require FCA approval pursuant to a Form 21 application (in respect of an OEIC) or a Form 251 application (in respect of an authorised unit trust).

- ***Is investor consent required?***
  Investor approval will undoubtedly be required if the conversion is taking place via a merger (or scheme of arrangement) and is highly likely to be required if the conversion is taking place within the same fund structure. The exception to this is where the NURS fund has not utilised its wider investment powers and there are effectively no changes being made to the fund's investment objective and policy or the way the fund will be managed in practice. Where this is the case it is likely the changes can be made without investor approval, although it will still be necessary to give investors 60 days' prior notice of the conversion.

- ***Are any other notifications or applications required?***
  As a NURS is an alternative investment fund ("AIF") for the purposes of the Alternative Investment Fund Managers' Directive ("AIFMD") it may be necessary to submit an AIFMD "material change" notification to the FCA. In addition, certain tax clearances will need to be obtained from HMRC where the conversion is to take place by a scheme of arrangement.

- ***How much will the conversion cost – and who will pay for it?***
  Management companies should be clear on whether the relevant rules and the constitutional documents and prospectus of the NURS permit the costs of the conversion to be paid out of the scheme property of the fund (and if so whether this meets the FCA's 'treating customers fairly' requirements). If it is anticipated that the conversion costs will be passed on to a third party, this should be discussed and agreed at an early stage by reference to the relevant contractual arrangements.

How Burges Salmon can help?

Our investment funds team has vast experience in dealing with a wide range of fund-related matters and FCA applications. If you would like to discuss any of the points raised in this feature or any funds-related matters please contact ***Victor Ondoro*** *or* ***Adrian Shedden.***

In Brief

Please note the following brief updates:

Securities Financing Transactions Regulation

Catch-up

In the Winter Edition of Authorised Fund Horizons we reported on the coming into force of the Securities Financing Transactions Regulation ("**SFTR**"), which imposes certain disclosure and reporting requirements as part of the latest piece of post-financial crisis legislation to affect UK fund managers.

Key developments

Since our last update, the key developments in this area have been:

- The publication and subsequent closure by ESMA of its SFT Discussion Paper, ESMA/2016/356, on 11 March. The Discussion Paper sets out the technical proposals for implementing the reporting framework under SFTR including the fields and the data to be reported under those fields, and the registration requirements for those Trade Repositories (TRs) which want to accept reports on security financing transactions. The deadline for submissions was 22 April and ESMA expects to publish a consultation paper early in Q3 2016. Ultimately, the draft technical standards will be submitted to the European Commission for endorsement by 13 January 2017.
- Publication of a joint statement by various industry bodies (being the Association for Financial Markets in Europe, FIA, the International Capital Market Association, the International Swaps and Derivatives Association, Inc. and the International Securities Lending Association) that can be used by market participants to comply with the new SFTR risk disclosure requirements in relation to transactions for the reuse of financial instruments received under a collateral arrangement (under Article 15 of SFTR, which comes into force on 13 July 2016).

What to do?

Given the imminent application of the Article 15 provisions, UCITS managers and AIFMs involved in the reuse of financial instruments received under collateral arrangements (whether directly or through delegates) should familiarise themselves with the requirements of Article 15 SFTR and the joint statement and look to put in place similar risk warnings into their own documents where appropriate.

*If you would like any further advice or assistance in relation to the SFTR please do not hesitate to contact **Gareth Malna** or **Victor Ondoro** in the first instance.*

Senior Manager and Certification Regime (SM&CR): An update for asset managers

Since the publication of our winter 2015 edition of Authorised Fund Horizons and our February 2016 update on the SM&CR the key development is of course that the SM&CR is now in effect (from 7 March 2016) in relation to UK banks, building societies, credit unions, PRA-designated investment firms and branches of foreign banks operating in the UK (collectively referred to as "banking firms").

What's in the pipeline?

Extension of the regime to all authorised financial services firms. The Treasury has previously stated that financial institutions that are not yet subject to the senior managers and certification regime (namely asset managers, hedge funds and broker-dealers) will be subject to the senior managers and certification regime no sooner

than 2018. The expectation is that the extended SM&CR is likely to result in a regime that is broadly similar to the regime for banking firms. The government has previously stated that the regulators will ensure that "the extended regime appropriately reflects the diverse business models operating in the UK market and is proportionate to the size and complexity of firms." How this will shape up remains to be seen.

General counsel and heads of legal

In our February 2016 update on the SM&CR we referred to the FCA's plans to consult on the pros and cons of capturing individuals with overall responsibility for the legal function within the senior managers regime. One potential "con" in this regard would be the possible tension between a GC's duty to their client/employer and their duty to the regulator (e.g. in relation to disclosure of privileged information) if they were to fall within the regime. The consultation is expected to commence in the summer of 2016 and we will continue to keep you updated.

"Rolling bad apples" and regulatory references

The FCA and the PRA are due to revisit their proposals for new regulatory references over the summer of 2016. The proposal was (in summary) that relevant firms seeking to appoint someone to carry out a senior management function or a certification function would be required to request a "regulatory reference" from all previous employers covering the past six years of employment. This stemmed from the recommendation in the June 2015 final report of the 'Fair and Effective Markets Review' that "… the FCA and the PRA should consult on a mandatory form for regulatory references, to help firms prevent the 'recycling' of individuals with poor conduct records between firms …" i.e., to combat the problem of so-called "rolling bad apples".

In October 2015, the FCA consulted jointly with the PRA on the new referencing requirements. A number of key areas were challenged by respondents and legal issues were also raised (including around data protection, the practicalities of updating historical references, the rationale of applying references to intra group moves, etc). Firms were also concerned about the timetable for implementation and their ability to put in place the necessary systems and processes in time for commencement of the new regime in March 2016. To allow sufficient time fully to consider the issues raised in the feedback the FCA delayed finalising the new regulatory referencing regime and has now implemented interim measures with the aim of confirming its final policy and the final rules in the summer of 2016.

What should I be doing in preparation (ahead of the extension of the regime)?

Asset managers should not be lured into a false comfort by the 2018 extension date. Proper planning and preparation for the extension of the regime will require the marshalling of resources and is likely to take some time. Successful implementation of the SM&CR will require significant co-operation between firms' legal/compliance and human resources functions. Firms that have not already done so should consider setting up cross-departmental committees and start thinking about an implementation plan. Firms should also be considering how they will deal with some of the issues that will need to be addressed ahead of the extension, such as: mapping responsibilities; screening employees; reviewing and updating processes, policies and procedures; training requirements; employee/HR issues that may arise; governance issues; IT resources and record keeping issues; implementation costs, etc.

*If you would like to discuss any of the points raised in this note please contact **Victor Ondoro** or **James Green** in the first instance.*

EU Savings Directive

The EU savings directive has been repealed and fund managers should look to update disclosure wording in their fund prospectuses accordingly and to reflect the relevant information reporting requirements in FATCA and the Common Reporting Standard respectively.

*If you would like further advice on this or other tax related issues please contact **Ian Carnochan.***

International Focus - Luxembourg

As mentioned previously we are introducing a new feature in which a firm from our International Funds Network will provide an overview of the current market trends, developments and hot topics in a key funds jurisdiction. In this edition **Isabelle Lebbe**, Partner Investment Management and **Jérôme Lasserre**, Senior Associate Investment Management of Arendt & Medernach summarise the latest developments in Luxembourg.

Luxembourg implements UCITS V

The bill of law implementing UCITS V in Luxembourg was adopted by the Luxembourg Parliament on 21 April 2016 by way of amending the Luxembourg UCI law. The adopted bill of law is merely a transcription of UCITS V into the UCI law, implementing the new depositary and sanctions regime and the requirement to establish remuneration policies for UCITS managers. In one respect the newly adopted law goes beyond the implementation of UCITS V, as it subjects Luxembourg funds established under Part II of the UCI law to the new and more stringent depositary regime for UCITS irrespective of their assets under management. The fund industry will certainly need further guidance as to the transposition timeline as well as further clarification as to the scope of the extension of the UCITS V depositary regime to Part II funds. In a press release dated 2 March 2016, the Luxembourg regulator, the CSSF, confirmed that it will generally apply the same implementation timeline as in ESMA Q&A 2016/ESMA/191 on the application of the UCITS Directive, and put in place a fast-track procedure, with respect to the updating of UCITS prospectuses, KIIDs and depositary contracts in relation to UCITS V. One can reasonably expect that the CSSF will adopt the same flexibility for Part II funds. The adopted bill of law also amends the Luxembourg AIFM law in requiring AIFMs to have their accounting documents audited by an independent auditor and in providing some clarification on the provision of non-core services. The adoption of this bill of law is an important

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step towards the implementation of UCITS V in Luxembourg. After promulgation by the Grand Duke, the amended UCI law will be published in the Luxembourg official journal and enter into force on the first day of the month following its publication, which is expected to be the 1st June 2016.

New ESMA discussion paper on UCITS share classes

The discussion paper released by ESMA on 6 April 2016 describes the nature of share classes, the reasons for their existence and the key elements of share classes. It builds on the feedback received from ESMA's first discussion paper on this topic. From a first reading it would appear that share classes with currency hedging would still be allowed. However, ESMA raises doubts as to whether duration- or volatility-risk-hedged share classes would be compatible with these principles.

CSSF FAQ concerning Luxembourg UCITS investment guidelines

On 8 December 2015, CSSF issued a FAQ covering a total of ten topics in relation to UCITS investment guidelines such as the eligibility of certain non-EU OTC bond markets, the interpretation of control and holding limits where the UCITS is organised as an umbrella fund and the investments in non-UCITS ETFs. Most of the questions and answers generally reflect the longstanding practice of the CSSF or repeat its positions such in relation to the eligibility of the US OTC Fixed Income Bond Market, the China Interbank Bond Market and the OTC bond market organised by the International Capital Market Association (ICMA).

The securities financing transactions regulation (SFTR)

The SFTR came into force in January 2016 and applies to funds engaging in securities financing transactions (SFTs), such as repo and securities lending, or transactions which involve the reuse of collateral, total return swaps and any transactions where collateral is received under securities or title transfer collateral arrangements. The SFTR imposes three new types of requirements, most of which will be phased in over the next two years: reporting obligation of SFTs to trade repositories following the model of EMIR; disclosure to investor obligations for managers of UCITS and AIFs; and transparency of re-use of financial instruments received under a collateral agreement. CSSF has taken the view that new sub-funds in an umbrella structure which existed before 12 January 2016 should benefit from the same grandfathering period as the existing umbrella itself in terms of pre-contractual disclosure requirements.

The upcoming reserved alternative investment funds (RAIF) regime

Luxembourg will introduce a new form of alternative investment fund, the RAIF, dedicated to well-informed investors, which is expected to enter into law during the second quarter of 2016. The RAIF will be managed by an external fully authorized AIFM subject to the requirements of the AIFMD and will benefit from the corresponding marketing passport but no supervision of the fund itself will be performed by the CSSF, making it an attractive vehicle from a time to market perspective. Market participants predict that the RAIF will serve to increase the competitiveness of Luxembourg as a financial centre and is a welcome addition to the Luxembourg fund structuring toolbox.

Implementation of the Common Reporting Standard (CRS) and repeal of the EU Savings Directive

The Luxembourg law implementing the Directive 2014/107/EU of 9 December 2014 and amending Directive 2011/16/EU of 15 February 2011 entered into force on 1 January 2016. The Luxembourg CRS law provides for the automatic exchange of financial information, as opposed to an exchange of information upon request, as the new standard applicable since 1 January 2016. The Luxembourg laws implementing the EU Savings Directive have been repealed accordingly.

Market trends

The rise of alternative UCITS

Managers are still looking to implement more sophisticated strategies under the UCITS format, covering a variety of asset classes and strategies, with a particular focus on CTA and credit strategies. Asset managers have also shown confidence in distressed debt, contingent convertibles and high yield investment strategies.

RQFII funds

Managers have shown ongoing interest in PRC strategies with the creation of various RQFII funds using specific QFII, RQFII quotas (including the 50 billion quota granted to Luxembourg) or Stock Connect.

Continued growth for the debt funds market

The market for debt funds continues to grow with over 70% of the top 30 debt fund managers worldwide operating in Luxembourg via all types of debt strategy including origination, secondaries, mezzanine and distressed funds.

Growing interest in the Luxembourg SIF

There has been growing interest in Luxembourg specialised investment funds (SIFs), demonstrating the disposition of managers to benefit from new flexible tools meeting investors' needs in terms of strategy.

Arendt & Medernach is the leading independent business law firm in Luxembourg. The firm's international team of more than 275 legal professionals represents Luxembourg and foreign clients in all areas of Luxembourg business law from our head office in Luxembourg and our foreign offices in Dubai, Hong Kong, London, Moscow and New York.

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