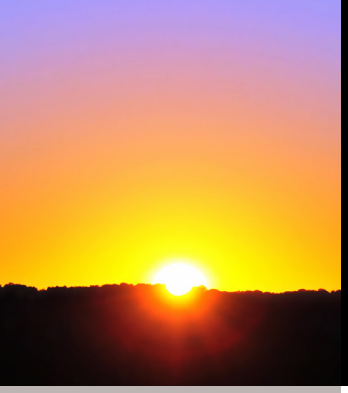

Newsletter

Authorised Fund Horizons

BURGES SALMON

Winter 2016

Welcome

Welcome to the Winter 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 look at the FCA's review of the asset management sector, UCITS V, the Securities Financing Transactions Regulation, EMIR, Authorised Contractual Schemes, MiFID II, the Small Business Enterprise and Employment Act 2015 and the Senior Managers and Certification Regime.

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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FCA asset management market study

What is it?

On 18 November 2015, the FCA announced the terms of reference ("**TOR**") for a market study it is conducting into the UK asset management industry. The study is being conducted under the FCA's powers derived from the Financial Services and Markets Act 2000 ("**FSMA**") with a view to assessing whether competition is working effectively in the industry, with the key areas of focus being:

- how asset managers compete to deliver value;
- whether asset managers are willing and able to control costs and quality along the value chain; and
- how investment consultants affect competition for institutional asset management.

In addressing these questions, the FCA will also consider whether there are any "barriers to innovation and technological advances."

How does it affect me?

The review has generated significant levels of attention and interest in the industry, due no doubt in part to a referral in the TOR to the FCA carrying out a "profitability analysis" as part of the review on the basis that "above average" levels of profit are perceived to be one indication that competition may not be working as effectively as it could be. The FCA has also been flexing its proverbial muscles by referring to its potential intervention powers should it conclude that competition is not working effectively – including rule-making (or removal of existing rules), the introduction of firm-specific remedies or enforcement action, proposing enhanced industry self-regulation and referring issues to the Competition and Markets Authority.

The FCA has been careful to clarify that it may alternatively decide to take no further action. However, there is understandable scepticism in the industry as to whether a clean bill of health is a likely outcome given the associated time, costs and expectations in instigating and carrying out such an investigation. Whether such scepticism is justified remains to be seen…

What next?

The deadline for providing comments on the TOR was 18 December and the FCA is now in the process of approaching market participants for information and data to assess the issues in the TOR. We understand a number of firms have already been approached with preliminary questions for their consideration in this regard. In terms of output the FCA has said it will aim to publish an interim report in summer 2016 setting out its analysis and preliminary conclusions and, "where practicable and appropriate", possible remedies to address any concerns identified. Its final report will then follow in early 2017.

What can I do?

Although the survey has understandably caused a degree of apprehension in the industry some firms are also viewing it as an opportunity for positive change, in particular regarding certain aspects of the pensions consulting industry. The Investment Association has already picked up on this and a number of other points in its response to the TOR on 18 December.

If your firm has the (dubious) honour of being approached by the FCA for information and data in relation to the study you should ensure you are able to demonstrate to the best of your ability how your business produces and incentivises good outcomes for investors.

If you have any queries please contact ***Tom Dunn*** *and* ***Victor Ondoro.***

UCITS V

What's new?

The long-awaited UCITS V Level 2 Regulation was finally published in draft on 18 December 2015, following a number of previous unofficial versions that were apparently leaked earlier in the year. The next step will be for the EU Council and the European Parliament to consider and approve the Regulation before its publication in the Official Journal and entry into force on the twentieth day following its publication. In theory the Regulation will apply six months after the date of its entry into force, which means there is likely to be a gap between implementation of the Level 1 Directive (on 18 March 2016) and the application date of the Level 2 Regulation. If this is the case ESMA may issue FAQs to address this. In practice we anticipate that most depositaries and UCITS managers will seek to be compliant with the provisions of the Level 2 Regulation by 18 March.

What does Level 2 cover?

As expected the Level 2 Regulation focuses on the depositary related requirements of UCITS V and includes more detailed provisions around the following aspects of the Level 1 Directive:

- the contractual particulars that must be included in the depositary agreement;
- the duties and obligations of the depositary, namely, safe-keeping, custody and record-keeping, ownership verification, oversight and cash monitoring;
- the depositary's initial and ongoing due diligence requirements in relation to the selection of sub-custodians including the steps to be taken to ensure the protection of the UCITS' assets against the insolvency of the delegate;
- the conditions under which a loss of a financial instrument held in custody will be deemed to occur and the conditions under which the depositary's liability will not be triggered; and
- requirements to ensure the operational independence of the depositary and the UCITS or the UCITS management company and provisions relating to conflicts of interest.

Are there any surprises?

The Regulation contains little unexpected content and broadly reflects the equivalent level 2 provisions under the Alternative Investment Fund Managers Directive ("**AIFMD**") with regard to depositaries. However, the insolvency related provisions are slightly different and likely to be more restrictive in terms of effectively limiting those jurisdictions where UCITS' assets may be held (compared to the rules under AIFMD).

In addition, the provisions relating to links or group links between the management company and the depositary (as referred to in the fifth point above) are more prescriptive than in the earlier leaked versions of the Level 2 Regulation. In particular, where the UCITS or UCITS ManCo appoints a depositary to which it has a link or group link, it must keep documentary evidence of its assessment of the merits of such a depositary compared with the merits of an independent depositary, along with a report describing the way in which the appointment meets certain pre-defined objective criteria.

What should I do?

Given the delayed delivery of the Level 2 Regulation it is likely that most UCITS managers will already have been contacted by depositaries to update existing depositary agreements (or put in place new ones in the case of authorised unit trusts). Following the publication of the Level 2 Regulation, UCITS managers may wish to revisit such agreements to ensure all necessary points are adequately covered – and also to check that depositaries are not seeking to improve their commercial position in a way that goes beyond what is required under the legislation.

*We can advise on all aspects of the implementation of UCITS V. Please contact **Tom Dunn**, **Victor Ondoro** or **Ursula McGuigan** in the first instance.*

Securities Financing Transactions Regulation

Background

Following EMIR and AIFMD, the latest piece of post-financial crisis European legislation to arrive in the UK is the Securities Financing Transactions Regulation which came into force on 12 January 2016. The Regulation relates to Securities Financing Transactions ("**SFTs**") which are broadly defined to include lending or borrowing of securities or commodities, repurchase transactions, buy-back transactions and margin lending transactions.

How will the changes affect my firm?

The key measures to be aware of are as follows:

- A transaction reporting obligation means SFT counterparties will have to report details of transactions to trade repositories no later than the working day following the conclusion, modification or termination of the SFT and keep a record of such transaction for at least five years.
- UCITS ManCos and alternative investment fund managers "**AIFMs**" will need to provide detailed pre-contractual disclosures to investors in relation to both the SFTs and total return swaps they are authorised to use. The information to be provided includes (among other things) a general description of the SFTs and total return swaps used and the rationale for their use, the maximum and expected proportion of AUM that can be subject to them, criteria to select counterparties, details of acceptable collateral and the policy on sharing returns generated by SFTs and total return swaps.
- In addition, UCITS ManCos and AIFMs will need to disclose the use of SFTs and total return swaps in the UCITS' half-yearly and annual reports and the AIF's annual report (as applicable) together with certain related information including (among other things) the amount of securities and commodities on loan and specified concentration data.
- Requirements to make prior risk disclosures and obtain written consent from counterparties before re-using financial instruments received under a collateral arrangement and to exercise any right to reuse in accordance with the terms specified in the written agreement.

When is this happening?

Although the SFT Regulation came into force on 12 January 2016 many of the requirements are subject to transitional provisions and will be phased in over the next two years.

However, it should be noted that the record keeping requirements apply with immediate effect, as do the fund transparency requirements at the second and third bullet points above, in respect of any UCITS or AIF launched on or after 12 January 2016 (including in respect of a new sub-fund of an umbrella fund that was launched prior to 12 January).

Funds launched prior to the entry into force of the SFT Regulation have until 13 July 2017 to comply with the new pre-contractual disclosure obligations for the existing funds, although the periodic reports for these existing funds will need to provide the specific information to be included in all such reports issued following 13 January 2017.

The re-use of collateral requirements will apply to UCITS ManCos and AIFMs from July 2016.

The transaction reporting requirements will apply for UCITS ManCos and AIFMs 18 months after the entry into force of certain ESMA regulatory technical standards, currently expected by January 2017 at the latest – so potentially not until late 2018.

What do I need to do?

In the first instance UCITS ManCos and AIFMs should consider:

- ensuring appropriate records are kept of any SFT that is concluded, modified or terminated following 12 January;
- updating their standard procedures to ensure compliance with the relevant disclosure requirements in respect of new funds and, in due course, existing funds; and
- where relevant, updating any applicable investment management agreement to ensure this clarifies the extent to which the delegate manager is contractually responsible for ensuring compliance with the record keeping, reporting and reuse requirements.

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

EMIR – all clear at last?

The most significant development in relation to EMIR since our Autumn newsletter has been the confirmation of an official timeframe in respect of the first clearing requirements under the regulation following the publication of a delegated regulation on 20 December 2015.

The clearing requirements will apply in respect of certain types of G4 currency (EUR, GBP, JPY and USD) interest rate derivatives, being basis swaps, float-for-floating interest rate swaps, forward rate agreements and overnight index swaps.

The timing of the requirements will vary depending on the status of the counterparty but for a UCITS or AIFM that is not a clearing member and which has less than €8bn of gross notional non-cleared OTC derivatives (at the level of the relevant fund) the specified date is 21 June 2017. Helpfully the delegated regulation clarifies that where a contract is concluded between two counterparties included in different categories, the date from which the clearing obligation takes effect for that contract shall be the latter date. However, it should be noted that the clearing obligation will apply not just in respect of new contracts entered into after 21 June 2017 (as applicable) but also pre-existing contracts that are still in existence and which have a minimum remaining maturity as at a specified date.

In terms of next steps we recommend that UCITS ManCos and AIFMs should:

- Identify any funds they manage where the investment strategy involves or may involve the use of interest rate derivatives falling within one or more of the relevant categories.
- Where portfolio management in relation to such funds is delegated to a third party manager, ensure the investment management agreement appropriately reflects who is (contractually) responsible for ensuring compliance with the applicable clearing requirements.
- Take steps (or ensure any delegate takes steps) to agree and put in place appropriate contractual arrangements to ensure applicable derivatives will be cleared through a central counterparty at the relevant time.

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

Focus on UK tax transparent funds

Whilst it is unusual to begin a horizon-scanning briefing in 2013, it is worth noting that the UK's regime for Authorised Contractual Schemes ("**ACSs**") has been around since 6 June of that year, when the insertion of section 235A into FSMA created the concept of the two types of ACS: (i) authorised co-ownership schemes and (ii) authorised limited partnership schemes. These schemes were introduced to align the UK investment funds regime with other European jurisdictions offering tax transparent pooling vehicles (in particular Ireland and Luxembourg) and facilitate the establishment of tax-transparent master-feeder structures as envisaged by UCITS IV.

So what's new?

On 13 November 2015 the London LGPS CIV Authorised Contractual Scheme became fully authorised in the UK by the FCA. The scheme, which is established as a co-ownership scheme, is the first of its kind for the UK pensions industry and is intended to enable London borough pension schemes to achieve cost savings and benefit from economies of scale that may not have previously been available for individual borough schemes. ACS structures are attracting considerable interest in the wider industry (including the pensions sector). Therefore, we summarise below their key features and potential benefits.

Classification and structure

ACSs, which can be structured either as co-ownership or partnership schemes, are available as UCITS, NURS and QIS (the London LGPS CIV is a QIS).

In a co-ownership ACS, the investors own the scheme property as tenants-in-common and it is held on their behalf by a depositary. The arrangements constituting the scheme are contractual and are set out in a deed between the authorised fund manager and the depositary. Co-ownership schemes may be in standalone or umbrella form. As with an OEIC or AUT the regulations provide for segregation between the assets and liabilities of sub-funds in an umbrella structure.

In the case of a limited partnership ACS, the investors are limited partners with their interest being treated as notional units. The scheme will be formed by deed, entered into by the general partner (as authorised fund manager) and a nominated partner which will be the only limited partner of the scheme on its formation. As in a co-ownership scheme legal title to the scheme property will be held by the depositary. The legal structure of a limited partnership scheme is similar to that of an ordinary limited partnership subject to the following three differences, which are intended to provide the necessary flexibility for the schemes to operate effectively:

- Investors are able to redeem interests in the fund without remaining liable for the partnership's debt.
- In the absence of wrongdoing on its part, the general partner will not be liable for the debts of the limited partnership.
- Partnership changes need not be published in the Official Gazette.

One significant difference between limited partnership and co-ownership ACSs is that a limited partnership scheme must be standalone and may not be structured in umbrella form.

Direct investment in an ACS by retail investors is limited to investors who invest at least £1 million, although other investors may potentially be able to access an ACS through a feeder fund (where applicable).

Tax features

A key benefit of the ACS regime is that the ACS is not itself subject to UK tax on income or gains arising from underlying investments. Investors are treated (at least in respect of income) as if they had invested in the assets directly. Having a tax transparent fund vehicle can often be a benefit for investors entitled to more favourable (or zero) rates of withholding tax under double tax treaties.

Income

Both types of ACS are transparent for income tax purposes. In other words, the ACS is not itself subject to UK tax on income. Instead, income is treated as arising to the investors directly and, if applicable, they will be subject to UK income tax or corporation tax accordingly. Investors therefore need to be provided with information about the income that arises.

Generally, there is no obligation on the ACS manager to withhold UK tax from distributions of income to investors (an exception is where there is UK rental income paid to a non-resident and there is no authorisation to be paid gross). Income on the underlying investments may be subject to withholding tax in the jurisdiction in which it arises, subject to any relief available under an applicable double tax treaty.

Capital gains

An ACS is not subject to tax on capital gains realised on underlying investments, whichever structure is used. For investors, however, the structure does make a difference. A co-ownership scheme is not transparent for capital gains purposes. In other words, investors in a co-ownership scheme are treated as if their interest in the scheme was an asset (and they are not treated as owning an interest in the underlying asset for these purposes).

Limited partnership schemes, on the other hand, are treated as transparent for capital gains purposes. This means that UK resident investors may be subject to tax, if applicable, on their share of any chargeable gains arising on the disposal of underlying assets of the scheme.

Whether a particular ACS structure is appropriate to use will depend on the intended underlying investments and investor base of the fund. We would be happy to discuss the practicalities of establishing an ACS, or to answer any tax or regulatory questions you may have about these schemes. *Please contact* ***Gareth Malna*** *or* ***Ian Carnochan*** *for more information.*

In Brief

Please note the following brief updates:

MiFID II

Implementation Update

Many of you will be aware that since our previous update there have been indications that the implementation of MiFID may be delayed by (at least) a year to January 2018. At the time of writing there has still been no official confirmation on this point and the minutes of the FCA's MiFID II implementation roundtable minute 1.3 stated:

"The FCA noted that there is still no clarity on whether the Commission will propose a delay to the transposition deadline, which is currently 3 July 2016, as well as the date of application. The FCA said that it would seek to provide clarity on the MiFID rules to those impacted as soon as possible and will provide them with an adequate time to complete their implementation work."

We will of course keep you updated as this develops.

Consultation Paper I (CP15/43)

In the meantime on 15 December 2015, the FCA published its first consultation paper on implementing the Markets in Financial Instruments Directive II (MiFID II), which closes for comment on 8 March 2016.

The content of CP15/43 is primarily relevant to trading venues, systematic internalisers, as well as those with algorithmic or high frequency trading strategies. However, a key consultation point for authorised funds and their managers is the FCA's proposal to avoid applying transaction reporting requirements to managers of collective investment schemes and pension funds. The FCA notes that the implementation of the original MiFID directive was 'gold-plated' to apply transaction reporting requirements to managers of collective investment schemes and pension funds. The requirements of MiFID II go significantly further than the original directive and the FCA's view is that direct compliance with the new transaction reporting requirements under MiFID II would be overly burdensome for such managers from a cost/benefit perspective. Although, collective investment scheme and pension fund managers will, of course, still be caught indirectly it remains to be seen whether they will be directly caught by conduct requirements once further consultations are proposed (or otherwise by future provisions in UCITS VI and AIFMD II).

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

The Small Business Enterprise and Employment Act 2015

Some of you will be aware no doubt of provisions in this legislation which stipulate a requirement from 6 April 2016 for all UK Companies Act private and public companies (with the exception of those with voting shares traded on certain EEA and other markets, including the Official List and AIM) to keep a register of people with significant control ("**PSC**"). The requirement will also apply to UK limited liability partnerships. As such, a register will need to be kept for any Companies Act companies (which do not fall within the exception) and LLPs, if any, within your group structures. Please see our briefing "Changes to UK company law – be prepared" if you require further details. However, having looked into the position, we can confirm that the requirement to keep a PSC register does not apply to open-ended investment companies (incorporated and authorised by the FCA).

*Please contact **Chris Godfrey** in the first instance with any queries.*

Senior Managers and Certification Regime (SM&CR)

In our Autumn edition we outlined the proposals by HM Treasury to extend the SM&CR to all sectors of the financial services industry to give effect to the FCA's stated desire to embed a culture of personal responsibility throughout the sector and said we would continue to keep you updated. The only developments of significance since then have been as follows:

Proportionality

The government 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." It will be interesting to see how the proportionality "test" is framed and how it works in practice – particularly for smaller firms.

Notifications of known and suspected rule breaches

The government also announced on 15 October 2015 the proposed repeal of Section 64B(5) of FSMA which would have required relevant authorised persons to notify the regulators if they knew or suspected that an individual performing a senior management function, or otherwise subject to the regulators' conduct rules, had failed to comply with any such rules.

On 6 January 2016, the FCA published consultation paper CP 16/1, which sets out a number of proposed technical rule changes to the SM&CR to reflect the cancellation of the coming into force of Section 64B(5) FSMA and amendments to the relevant forms to remove references to notifications of known and suspected rule breaches. The result is streamlined reporting requirements so that the forms only require firms to inform the FCA of disciplinary action taken against staff as a result of a breach of one or more of the FCA's Rules of Conduct. The pre-existing obligation to report material breaches of the FCA's rules will however remain. Firms, therefore, will still be required to notify the FCA of the most serious issues concerning their staff.

*If you would like any further advice or assistance in relation to the SM&CR please send your queries to **Victor Ondoro** or **James Green** in the first instance.*

Watch this space…

In our next edition we intend to introduce 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.

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

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