BCLP AUTUMN FUNDS FIRST UPDATE

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INTRODUCTION

Welcome to our Funds First Update: a snapshot of some of the main developments and upcoming changes that we think will be of interest to fund managers, fund investors and to the funds sector as a whole. Despite the understandable focus on COVID-19, regulators and legislators have still been busy and there is much that managers and investors should be keeping watch on over the next few months. In particular, there is news of ESMA's review of AIFMD; an update on Brexit; what to expect from the revised financial promotion approval regime; an update on ESG developments and on transparency initiatives; and where we are on DAC 6 and its application to funds.

Please feel free to call any of the BCLP Investment Management team or your usual BCLP contact if you would like to discuss any of the issues raised in this briefing in more detail, including how they may apply to your specific fund structures, business and planning.

AIFMD – ESMA'S LETTER TO THE EUROPEAN COMMISSION PENDING AN AIFMD II CONSULTATION

ESMA's 19 August 2020 letter to the European Commission (the Commission) recommends various changes to AIFMD pending the Commission's review (and an expected "AIFMD II"). Any changes will also influence any future review of the UCITS Directive. A Commission consultation is expected imminently (although that has been said many times before in the past couple of years) and the industry will be preparing to respond, based on the extent that the Commission chooses to adopt, ignore or add to ESMA's views. Whilst many of the points raised are necessary changes resulting from developments in practice or seeing how the regime has worked since it came into full effect over six years ago, there are other areas (particularly around the delegation model and the scope of the Directive) that could have a far reaching effect. In short, if ESMA's views hold sway, there could be some fundamental changes to the scope and application of the regime as well as likely necessitating some rethinking by firms of their Brexit contingency plans.

In the meantime, we have flagged in the table below those ESMA proposals we think are likely to cause the biggest impact in the funds arena.

Issue	Explanation	Comment
Limits on the use of delegation	ESMA questions whether funds managed on a delegated basis are effectively managed by the AIFM	Although ESMA mentions an expected uptick in delegation of portfolio management to non-EU

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	and suggests that the Commission consider: (i) imposing quantitative limits on the maximum permissible extent of delegation (eg minimum headcount levels and specific amounts of management fee revenue that must be retained by the EU AIFM); or (ii) restricting the functions that can be delegated in the first place by providing a list of core or critical functions that have to be performed by the AIFM.	entities on Brexit, these proposals would have a wide impact on fund structuring, and there is likely to be industry pushback, in particular as the current models are standard industry practice. Fund managers will also be keen to ensure they can preserve delegation arrangements set up as part of their Brexit planning.
Introduction of a level playing field in delegation structures	ESMA recommends new rules requiring delegates, irrespective of their location, to be subject to the AIFMD regulatory standards.	This would avoid 'regulatory arbitrage' in delegation structures. ESMA also raises concerns over temporary staff secondments in the context of substance and delegation, suggesting legislative clarifications to bring these into line.
More functions caught by the delegation rules	ESMA proposes that all functions listed in Annex 1 to AIFMD are covered by the delegation rules.	This would capture a wide range of ancillary activities, beyond portfolio and risk management – including administration, legal and accounting services and regulatory compliance.
More scrutiny of 'host' AIFMs	ESMA calls this 'white-label' model into question, noting that some member states doubt that it is AIFMD compliant. ESMA argues that, if allowed to continue, the model should be subject to increased regulation eg to tackle conflicts of interest and investor protection risks.	ESMA's concern is on the basis that the fund sponsor/investment adviser is the client of the host AIFM as well as its delegate.
Refining of AIF key concepts	ESMA proposes: → a new definition of 'leveraged AIF'; → a standardised EU-wide definition and approach to reverse solicitation; → further defining 'AIFs' consistent with ESMA guidelines on key concepts and clarifying the joint venture definition; and → to clarify the 'professional investor' definition. These illustrate ESMA's wish to have a more harmonised and centralised approach, alongside its	The ESMA letter was light on the detail of these proposals, so how they take shape (if at all) will be key. Nonetheless, these are areas that should be watched closely by firms. If ESMA's views are implemented, it is likely that many joint ventures which currently fall outside the AIFMD regime could be brought inside. This would have a significant impact on new structures being put together but also, in the absence of grandfathering provisions, could necessitate significant restructuring and potentially additional costs for existing JVs.

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	concerns around a level playing field and a focus on risk.	The industry has been asking for a semi-professional investor regime for some time so the suggestion that ESMA is willing to accommodate the request should be good news. However, the ESMA letter appears to suggest that passporting may not be available for any such new category which would mean it came with limited practical benefit.
External valuer liability	ESMA proposes that AIFMD is amended so that an external valuer is only liable to the AIFM for any losses suffered because of the external valuer's gross negligence.	A welcome proposal as in some jurisdictions the current simple negligence provision acts as a disincentive for external valuers and is not always an insurable risk.

BREXIT – POSITIVE NEWS ON REGULATORY CO-OPERATION AGREEMENTS (BUT NOT MUCH MORE)

The industry welcomed the July 2020 ESMA/FCA confirmation that the previously agreed regulatory co-operation agreements will take effect at the end of the transition period on 31 December 2020. This means that many cross-border activities of third country firms, specifically delegation and marketing, will be able to continue. In the absence of these co-operation agreements, UK managers would not be permitted to act as delegated portfolio managers of EU AIFs (a key plank of many contingency plans) or register for marketing into EU27 member states under the Article 42 national private placement rules (NPPRs).

However, this has to be set against considerable uncertainty (at the time of writing) on how and when we will see an outcome of the Brexit process; the adverse economic effects of COVID-19 and ESMA's push (summarised above) to restrict delegation models - which combined have the potential to aggravate existing risks at the end of the transition period and cause increased disruption to firms and markets.

Most firms therefore continue to prepare for a no deal Brexit and should assume they will need to make use of their contingency plans. The situation for EU27 firms and investment funds providing services or marketing funds into the UK is relatively rosy. Following the FCA's August update, those who have not yet notified and intend to use the Temporary Permissions Regime (TPR) to be able to continue operating as they had pre-Brexit under a temporary FCA licence, or who need to update their existing TPR licences, can do so via the FCA notification window that re-opens from 30 September. However, the extent of reciprocal arrangements (transitional access arrangement for UK firms providing services into the EU27 member states) has to be reviewed on a case-by-case basis. In the absence of a temporary permission being available, the UK firm or fund will need to stop all activities immediately following Brexit until they obtain a fresh licence or make a new Article 42 NPPR notification.

HM TREASURY PROPOSES CHANGES TO THE FINANCIAL PROMOTION APPROVAL REGIME

HM Treasury (HMT) published a consultation paper on 20 July 2020, proposing changes to the regulatory framework for authorised firms approving financial promotions of unauthorised firms. The consultation is open until 12pm on 25 October 2020, following which the government will analyse responses to the consultation and respond by setting out next steps on what the analysis revealed and which policy options it intends to take forward. Financial promotions is an

area that is getting a lot of regulatory attention at present. In addition to this consultation, the FCA also published its consultation CP 20/8 over the Summer on the marketing of speculative illiquid securities (including mini-bonds) and making its temporary rules permanent, and HMT separately issued a consultation (also in July) on changes to the rules on promoting cryptoassets that could bring non-security cryptoassets into the financial promotions regime. Promotions are therefore very much on the FCA's radar and firms should therefore take particular care in this regard.

Under the current legislative framework, an authorised person is able to approve any financial promotion of an unauthorised person and currently there is no specific process through which a firm is required to be assessed as suitable or competent before it can approve financial promotions. As per the FCA's Dear CEO letters last year, compliance with regulatory requirements regarding the approval of financial promotions has been increasingly on the FCA's radar, with the FCA continuing to remind firms of their obligation to ensure that financial promotions comply with the relevant FCA rules before they are approved. The consultation paper notes that whilst financial promotions made by unauthorised persons (that do not otherwise fall within an exemption) should be subject to approval by an authorised person, HMT is of the view that the current framework is not operating effectively and therefore should be updated.

The new proposals seek to amend the financial promotions regime to create a new gateway, which would require authorised persons to obtain FCA consent before being able to approve financial promotions by an unauthorised firm. The consultation provides that the creation of a 'new gateway' would ensure that the FCA is able to determine that a firm's systems, governance and overall approach to the assessment of financial promotions are robust before it is able to start approving financial promotions. It would also enable the FCA to take a less 'reactive' approach to supervision in this area, as the FCA would be able to first assess whether the authorised firm is suitable and competent to provide such approval.

The proposals have potentially far-reaching consequences across the funds industry, particularly for fund managers who rely on host AIFM and ACD service providers. The direct impact being that such authorised firms will need to apply either for consent to remove the applicability of the general restriction or to amend their permissions (depending on which option is adopted). The consultation paper does not detail the proposed suitability assessment that the FCA would seek to adopt when assessing an authorised firm's suitability to approve the financial promotions. However, it is likely that this will involve closer scrutiny of a firm's systems and controls to ensure that they reflect the standards set out in the FCA Handbook regarding the approval of financial promotions.

Clearly, there is a need to better police poor practices by firms approving financial promotions for third parties, but it remains to be seen whether the FCA actually needs additional powers, and whether those being suggested would simply act to stifle innovation and new entrants to the market.

ESG DEVELOPMENTS

In order to finalise the legislative framework of the EU's sustainable finance package, the European Supervisory Authorities have been consulting on draft regulatory technical standards and proposed ESG disclosure standards. Some of the themes that have been fed back are:

→ Interconnectedness of sustainable finance regulations: harmonising frameworks as well as sequencing (currently operational requirements are likely to take effect around 9 months after the Disclosure Regulation is in force).

→ The importance of assessing all material risks (credit, liquidity, sustainability) equally and for sustainability risk assessments to be conducted in both qualitative (and quantative) terms, in particular when appropriate and reliable data is not available.

→ To recognise nuances between different asset classes, for instance in real estate the sustainability preferences are not reflected in all investment strategies and to consider alternative tools and metrics for measuring ESG performance.

For background on this topic, see our recent briefing ESG for fund managers: legislative drivers, sustainability frameworks and practical points.

DAC 6

DAC 6 is a new regime, which went live on 1 July 2020 (but with a two year look-back) under which intermediaries and/or taxpayers must report to an EU tax authority information about cross-border arrangements that fall within one or more of a list of specified Hallmarks, with a view to the information being exchanged with other EU tax authorities. A "cross-border" arrangement is one which concerns either at least two EU member states, or at least one EU member state and a third country. For DAC 6 purposes, the UK is to be treated as if it were still a member of the EU (and this is expected to continue after the Brexit transitional period).

Funds transactions will need to assessed as to whether or not they fall within scope of the reporting requirements. Under the UK rules, the below are unlikely of themselves to fall within scope:

→ the use of general industry standard documentation (eg constitutional fund documents, subscription agreements, PPMs and FCA-regulated products);

→ carried interest structuring (as per industry practice and the 2003 BVCA/HMRC MOU) that constitutes 'normal commercial practice' and is not contrived;

→ arrangements with jurisdictions that have beneficial ownership registers, or a mechanism for authorities to obtain the information; or

→ the use of intermediate holding companies in normal commercial arrangements.

However, the Hallmarks are extensive and wide-ranging, apply to purely commercial transactions, or those motivated by reasons other than tax, and in different scenarios (for instance some Hallmarks require a tax main benefit test to be met). The identification process should therefore be done with this in mind and based on the specifics of each transaction.

Due to the impacts of the COVID-19 pandemic the EU is allowing member states the option to defer the first reporting deadlines under DAC6 by 6 months. The UK has opted to delay and accordingly the following reporting deadlines apply:

→ For arrangements where the first step in the implementation took place between 25 June 2018 and 30 June 2020 (the two year look-back) - reporting is now due 28 February 2021.

→ For arrangements where the trigger for reporting falls between 1 July 2020 and 31 December 2020 - reporting is due within the period of 30 days beginning on 1 January 2021. Reporting could be triggered by any of: arrangements made available (or ready) for implementation, or where the first step in the implementation takes place, or a service provider provides aid, assistance or advice. (Essentially this transitional period creates a second type of "catch-up" reporting in addition to reporting for the two year look back).

→ For arrangements where the trigger for reporting arises on or after 1 January 2021 - reporting is due within 30 days of the earliest trigger for reporting.

There are significant penalties for non-compliance, with local variances. In the UK these are generally likely to be up to £5K and in the worst cases, there could be a daily rate of £600 while the failure is continuing or even £1m per transaction if the tax tribunal considers that the daily rate of £600 is insufficient. Penalties may be reduced/cancelled if there is a reasonable excuse (for instance having reasonable procedures in place to identify reportable cross border arrangements and secure compliance with the rules).

To read more about the DAC 6 regime, please click here to read our brochure.

GOVERNMENT RESPONSE TO ITS CONSULTATION ON OPTIONS TO ENHANCE THE ROLE OF COMPANIES HOUSE AND INCREASE THE TRANSPARENCY OF UK CORPORATE ENTITIES

On 18 September 2020, BEIS published its response to the May 2019 consultation that introduces a package of multiple transparency proposals. For instance, to give the Registrar more powers to question and challenge information submitted to it, remove or amend inaccurate information from the register, and when to issue certificates of good standing. We have picked out a handful of proposals of particular interest to funds:

- → Moving the 2018 UK limited partnership (UKLP) proposals forward, BEIS proposes allowing UKLPs to be struck off the register following a court order, using a robust notification mechanism, with operational safeguards and an appropriate restoration procedure in place. No further details are provided, although BEIS reiterates that the process will be designed in a way that balances the need to deter criminal activity whilst protecting the interests of innocent parties. In addition, that it will be in conjunction with a procedure for voluntary strike off.
- → Compulsory identify verification for general partners in UKLPs, designated members in UK LLPs, as well as company directors and people with significant control (PSCs), using a digital process.
- → AML-supervised entities that file information on behalf of a company, UKLP or LLP will need to open an 'agent account' with Companies House and provide certain information about themselves. Individuals can still file information on an entity's behalf, subject to completing verification checks.

Further consultations will follow along with draft legislation and proposed transitional measures, where necessary, when Parliamentary time allows.

EXTENSION OF UK REGISTER OF BENEFICIAL OWNERSHIP OF TRUSTS

Proposed changes to the Trust Registration Service (TRS) in the UK under 5MLD were recently finalised.

We would highlight three key provisions in the published Regulations (as set out in draft in July 2020). First, trustees of UK trusts that are not exempted must now collect relevant information on beneficial ownership and (for trusts existing before 9 February 2022) register by 10 March 2022; or (for trusts falling within scope that are created after 9 February 2022) within 30 days. Secondly, from 10 March 2022, when entering into a new business relationship with a trust that is required to register, Obliged Entities (businesses regulated for AML/CTF purposes) must collect proof of registration. Thirdly, From 10 March 2022, there is broader access to the information held on the register, to include third parties who can demonstrate a legitimate interest.

Getting in touch

When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

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