2020 FUNDS FIRST UPDATE

February 2020

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Welcome to our Funds First Update. In this briefing we set out an overview of some of the main developments and upcoming changes that we think will be of impact to fund managers, fund investors and to the funds sector as a whole.

This briefing is set out in four sections: a summary of some of the most recent regulatory developments; other key hot topics (including developments in tax and sustainable finance); a brief look at some of the other principal developments that you should be looking out for in 2020 and a real estate funds market overview along with some observations. For some of the topics covered we have highlighted action points.

If you are interested in developments across the broader financial services sector, please also see our 2020 Emerging Themes publication, which covers a number of areas that are likely to be of particular interest to managers, including articles on the FCA's Senior Managers and Certification Regime (SMCR); ESG and sustainable growth; the changing landscape of tax risk and the FCA's continued focus on culture within firms. Our theme this year is "Global Regulation, Local Solutions".

Please feel free to call any of the BCLP Funds & 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.

Regulatory developments

The FCA takes a tough stance on key risks of harm posed by (i) asset managers; and (ii) alternative investment firms - as set out in its 20 January 2020 Dear CEO letters

These letters provide a regulatory barometer for managers on the issues where the FCA believes progress is required. In particular, the Dear CEO letters should be seen by the asset management and alternative investment sectors as an indication of the areas of their business where the FCA will be focusing its attention and of where managers should be ready to engage with the FCA when requested. We would not expect any of the areas to cause surprise to the affected communities as they are all topics that the FCA has been looking at in the past year. As a result, they should already form part of a firm's compliance workstreams - for instance, liquidity management; effective governance and implementation of SMCR; LIBOR transition; Brexit; retail investor exposure to alternative investment products and market abuse, integrity and disruption. Nonetheless, it is a useful reminder to firms at the start of the year of where the FCA's attention is likely to be drawn. Although published as two separate letters, the FCA recognises that many of the issues raised will be common to both types of firms and that business models will often overlap.

Although not expressed, these letters can be viewed in the context of three events: the high-profile collapse of Neil Woodford's investment empire, the liquidity difficulties experienced by many property funds following the Brexit vote in 2016, and the more recent real estate fund gatings in December 2019. The FCA has been heavily criticised from many quarters for its lack of foresight and oversight on each of these occasions. This stock-taking exercise is here to remind fund managers of their own duties but also provides an important insight into FCA priorities.

We have set out below a few of the topics that the FCA has identified in these letters that we think are likely to be of interest.

- → An evaluation of implementation of the Asset Management Market Study, in particular the requirement that has applied since September 2019 for authorised fund managers (AFMs) to assess the overall value delivered to investors.
- → A focus on how effectively new product governance provisions under MiFID II have been implemented (the FCA has concerns around the potential for a 'host' authorised corporate director (ACD)'s responsibilities to be compromised in certain instances).
- → To ensure that asset managers proactively manage technology and cyber risk appropriately. This is part of the FCA's initiative to strengthen the ability of financial services firms and market infrastructure to respond to, and quickly recover from, business disruption.
- → A focus on investment risks when offering products and managing investments, for instance a robust approach when complying with marketing and financial promotion rules or assessing whether or not a retail investor can 'opt up' to professional status.

Liquidity management in open-ended funds investing in illiquid assets

Liquidity management in funds remains a hot topic in 2020. The FCA's rules and guidance in its September 2019 Policy Statement on illiquid assets and open-ended funds include a new fund classification, "Funds investing in illiquid assets (FIIA)", new rules on suspension, on liquidity management, risk warnings and other disclosures. Although not in force until 30 September 2020, the FCA is encouraging AFMs and depositaries to consider adopting some of the measures earlier (eg increased disclosure and improved liquidity management) where it would be in customers' interests and the changes do not conflict with existing rules. See our briefing Illiquid assets and open-ended funds: the FCA's final rules on handling liquidity risks during market uncertainty, for more.

The Bank of England and the FCA are still exploring this area: the December 2019 Financial Stability Report sets out an initial blueprint which would impact liquidity management and monitoring, redemption and fund pricing and mechanics. The FCA's Dear CEO letter (mentioned above) raises liquidity as a specific priority area. It is also flagged in ESMA's Annual Report on the EU AIF market (mentioned below).

As well as the liquidity management, stress testing and related risk and disclosure requirements that a firm may be subject to (whether by virtue of being an AFM, AIFM or investment firm), those firms must also be on top of the impact of other initiatives and best practices (both pre and post fund launch). For example, they should look to IOSCO's recommendations on fund liquidity and ESMA's guidance on liquidity stress testing in AIFs and UCITS.

Action point: In-scope AFMs should consider adopting some of the new rules before they become mandatory in September. The FCA points out that risks of suspension can be reduced by better aligning redemption terms with the liquidity of assets – for example by avoiding offering daily dealing where this may not be sustainable without loss of value; or by choosing to operate as a closed-ended or listed fund instead. Fund managers should therefore continue to monitor and explore the full spectrum of fund options that may fit their model, including closed-ended funds and alternative products.

Investment Firms Regulation and Directive (IFR/IFD) - a new prudential regulation framework

The new framework, which applies from 26 June 2021 to all MiFID investment firms, will establish a new set of classifications and capital requirements. This is to reflect perceived systemic significance of investment firms as well as impose governance and remuneration requirements. Although alternative investment fund managers (AIFMs), along with UCITS

ManCos, are not directly in scope, they will still need to consider the impact of these changes on their own capital requirements. This is because references to CRD IV/CRR in the AIFMD and UCITS Directive will now be construed as references to the new IFD/IFR and so AIFMs and UCITS ManCos will still need to understand how these new tests will apply to them when measuring their own capital requirements. Furthermore, many fund manager groups will contain MiFID investment firms, whether as delegated managers or advisers to other group managers or third party portfolios, or as distributors.

There is a five-year transition period for existing investment firms: broadly, where the ongoing capital of existing investment firms, as calculated under the new framework, is more than double the amount calculated under the current CRD IV/CRR framework, then they may limit their capital requirements during this transition period, to twice the current amount.

See our briefing, Investment Firms: a new prudential framework, for more.

Action point: Even though supplemental rules are still to be finalised and there remains uncertainty around implementation by the UK post-Brexit, firms should start to assess now what impact the new requirements could have on them. In some cases the impact may be material and it may be necessary for firms to reorganise group structures or vary their permissions.

Discontinuation of LIBOR - asset managers need to increase preparations for the disappearance of LIBOR at the end of 2021 and to transition out of LIBOR instruments

In January the FCA and PRA issued a joint letter to senior managers responsible for implementing LIBOR transition plans, emphasising their intention "that sterling LIBOR will cease to exist after the end of 2021." Both entities support a Working Group on Sterling Risk Free Reference Rates, which has set a number of targets for the key transition year of 2020, including a further shift from LIBOR to SONIA in derivative markets, ceasing issuance of sterling LIBOR-based cash products maturing beyond 2021 by end-Q3 2020 and significantly reducing the stock of LIBOR referencing contracts by Q1 2021. Additional FCA and PRA supervision of firms will aim to assess whether enough progress has been made by mid-2020, or whether additional supervisory measures should be implemented. Firms will need to continue to consider legacy contracts that are already in existence and are expected to continue beyond 2021, any amendments or alternative solutions (ie to convert the contract to reference an alternative risk-free rate), any consents that may be needed and the potential for any mismatch with any hedging contract.

Action point: The 2019 FCA guidance set out the need to appoint a senior manager responsible for overseeing the LIBOR transition, and to detail such responsibility in the individual's Statements of Responsibilities, while also recommending that firms ensure they have robust governance arrangements in place to manage any risks that the transition may present. Now the regulators are stepping up their oversight, since the Bank of England's Financial Policy Committee aims to determine progress by the summer. Firms should generally accelerate transition plans and anticipate the need to discuss and prepare data on LIBOR transition, bearing in mind that by 2022 LIBOR will be no more.

AIFMD - removing barriers to cross-border distribution of investment funds and new rules on depositary safe-keeping obligations

From August 2021 new legislation aims to "boost the cross-border market for investment funds" and "eliminate current regulatory barriers to the cross-border distribution of investment funds in order to enable a better functioning Single Market and economies of scale". Of particular interest are the new rules on "pre-marketing" which mean that managers will be able to have initial discussions with prospective investors in common across the EU and test the market before documents are finalised, and without having had to fully commit to a particular regulatory marketing strategy. Although the provisions apply to EU AIFMs only, a reference to the harmonised rules not disadvantaging EU AIFMs over non-EU AIFMs may mean that local regulators (national competent authorities or NCAs) apply this new approach across the board.

EU AIFMs can carry out "pre-marketing" activities in relation to AIFs pre-launch, or for established AIFs that are not yet notified for marketing in the member state where the investor is domiciled or has its registered office. To qualify, pre-marketing must not amount to an offer or placement (no subscription documents can be available, whether draft or final form) and for funds pre-launch, only draft fund and offering documents can be in circulation. In practice, this means marketing teaser documents and draft offering and fund documents can be used at this early stage, provided it is clear that they are subject to change and do not constitute an offer or invitation to subscribe. New operational compliance rules apply (eg notification requirements).

This legislative package also contains provisions relating to reverse solicitation, marketing communications, retail investors, ceasing marketing and fees and charges that can be levied by NCAs. A couple of additional points of note:

→ The AIFM will be deemed to be "marketing" (and therefore, for an EU AIFM, need to have a marketing passport) where an EU professional investor subscribes to an AIF within 18 months of starting to pre-market, where that AIF was referred to or established as a result of such pre-marketing. This rules out reliance on reverse solicitation (where an investor approaches the manager on its own initiative and therefore the manager has not engaged in marketing) in these circumstances.

→ Following de-registration of an AIFM to market in a member state, that AIFM cannot engage in "pre-marketing" for a 3 year period, in relation either to the EU AIF(s) referred to in the notification or in respect of similar investment strategies or ideas. Although this reduces compliance costs and reporting, it may curtail an AIFM's future ability to pre-market a similar investment strategy in that jurisdiction.

See our briefing Update on reducing barriers to the cross-border distribution of investment funds for more.

From 1 April 2020 amended rules on depositaries' safe-keeping obligations of AIFs will apply. The rationale for this is to align depositary/custodian obligations in order to ensure protection of assets safe-kept on a client's behalf. A depositary will be subject to new obligations regarding clear identification and traceability of assets belonging to a particular AIF, including a requirement for asset segregation at the delegate level where a depositary has delegated the safe-keeping function. Similar rules are to be applied to UCITS in parallel.

Action point: Fund managers should be prepared for member states to adopt the new rules on "pre-marketing" in relation to the national private placement regime (NPPR) as well as the AIFMD marketing passport. Whilst the levelling of the playing field will help to allow AIFMs to conduct pre-marketing in member states where they could not previously do so, they may also find that they have to conduct pre-marketing exercises in member states where they are already doing so in a slightly different manner once these rules take effect. Firms will also want to proactively ensure that they take note of the new rules, in particular for any fundraisings taking place that may span the August 2021 implementation.

SMCR - implementation of 9 December 2019 extension to authorised fund managers (and launch of new financial services directory)

Since 9 December 2019 the FCA's Senior Managers and Certification Regime (SMCR) has applied to all FSMA-authorised firms (replacing the existing approved persons regime), as well as to branches of non-UK firms with permission to carry out regulated activities in the UK. Fund managers will have already had to undertake some significant changes to their governance arrangements in 2019, depending on their classification as Limited Scope, Core or Enhanced firms.

The new milestone for these solo-regulated firms is 9 December 2020, when the Individual Conduct Rules will apply to all staff (except those carrying out a small number of purely administrative roles that are specified in the FCA's rules): for example, to pay due regard to the interests of customers and treat them fairly and to be open and co-operative with regulators. In our view this is one of the most significant changes for the majority of people working at FCA-solo regulated firms, most of whom have never been accountable directly to the regulators for their personal conduct.

Identifying which staff are carrying out Senior Management Functions, and which are Certified, may not always be obvious. For example, Certification Staff include those involved in a significant management function (previously SF29) but who are not Senior Managers.

Action point: Framed as "an opportunity to deliver high standards of governance" in the FCA's Dear CEO letter to asset managers mentioned above, managers should ensure that their Conduct Rules training is implemented in time and that they have carried out fit and proper assessments of individuals under the Certification regime by 9 December 2020. Also that they start uploading data on in-scope individuals onto the new FCA Directory. Themes to be alive to in 2020 are: increased FCA scrutiny on how the SMCR rules have been embedded into a firm's business; any additions to the regime (for instance, oversight on LIBOR transition, as mentioned above); as well as the FCA's cross-sector focus on culture.

PRIIPS amends - European Commission's review now expected in 2020 (delayed from end 2019)

We are expecting proposals from the European Supervisory Authorities (ESAs) to amend PRIIPs KID requirements; alongside the European Commission's PRIIPs review report. These will reflect feedback from various workstreams around scope and content of KIDs, in particular suggestions that retail investors are given inappropriate expectations about possible returns and that PRIIP manufacturers should provide a warning in the KID to ensure that retail investors are fully aware of the limitations of the figures provided in the performance scenarios.

In January a group of industry bodies wrote to the Commission warning that the EU's approach to fixing problems with the regulatory technical standards (RTS) of PRIIPs Regulation is 'fundamentally flawed and will negatively impact consumers'; asking the Commission instead to conduct an analysis of the PRIIPs framework as part of its official review of the Regulation, and develop solutions that, 'based on solid evidence, will effectively improve consumer understanding and be workable for all PRIIPs in the different markets'.

Whilst firms can expect some movement on the PRIIPs regime, it is unlikely that there will be the complete overhaul that many have asked for.

5MLD: extension of UK money laundering regulations (MLR), including on the Trusts Registration Service

Changes to the UK's anti-money laundering regime came into force on 10 January 2020. The UK implementing regulations were published on 20 December, followed by HMT's response to the consultation and a further consultation on the trust registration elements of 5MLD (that closes on 21 February), on 23/24 January. Risks of money laundering and terrorist financing are likely to receive specific attention from the FCA (as stated in its Dear CEO letter for alternative investment firms).

There are three key areas of interest for funds. First, extended scope and access to the Trusts Registration Service, which requires all UK resident express trusts (unless the trust falls within specified categories of excluded trusts, including co-ownership trusts that exist solely for the purpose of jointly owning UK land) and certain non-UK resident express trusts and their beneficial owners to be registered in a central national register. The government is still considering whether bare trusts and nominee arrangements should be excluded from having to be registered. Another important area awaiting clarity is the government's position on which non-UK trusts entering into business relationships in the UK will be within the scope of the extended rules. What the government concludes will determine whether or not beneficial owner information of, for example, a JPUT with no UK trustees and no UK tax liability but that engages a UK service provider, will potentially be available to the public under the new regime, without any 'legitimate interest' safeguard.

Secondly, from 10 January 2020 when setting up a new business relationship, 'relevant persons' (a wide range of businesses deemed at risk of being involved in money laundering or terrorist financing) have to report discrepancies between the beneficial ownership information available to them and that in the central registers to Companies House (eg the Register of Persons with Significant Control (PSC) relating to companies, UK limited liability partnerships and Scottish partnerships) via a bespoke reporting mechanism. The Registrar of Companies will then investigate and resolve the discrepancy. Companies House guidance confirms that this relates to material factual discrepancies such as a missing PSC or an incorrect address, rather than typing mistakes or an attempt to seek disclosure beyond the information required under the

PSC rules. Excepted from these new rules is information protected by legal professional privilege (belonging to the relevant person).

Thirdly, some asset managers may now be subject to the rules when they were not previously – the definition of 'relevant persons' has been extended to include cryptoasset exchange providers, custodian wallet providers and high value property letting agents. The new rules also bring changes to customer due diligence, enhanced high risk third country due diligence and new MLR policies, controls and procedures.

Action point: Given the expanded scope and depth of the UK MLR, it is essential that those firms subject to them (in particular for those not previously caught) are aware of their new obligations, both to HMRC and the FCA as well as in relation to internal compliance policies and training. The new TRS registration deadlines should be noted:

- → **Trusts set up before 6 April 2021.** If the trustees incur a liability to one of the specified taxes for the first time the trust must be registered by 31 January after the tax year in which the liability arose; otherwise the trust must by registered on or before 10 March 2022.
- → **Trusts set up on or after 6 April 2021**. Trusts set up on or after 6 April 2021 but before 9 February 2022 must by registered on or before 10 March 2022. Trusts set up on or after 9 February 2022 must be registered within 30 days of being set up.

Once a trust is registered on the TRS, trustees will have 30 days from when they are aware of any changes to update the details.

See our recent briefing A rag-bag of changes to UK money laundering regulations for more.

Hot topics

Life after Brexit

The UK officially left the EU on 31 January, albeit an immediate transition period means that all rights and obligations will continue up to 31 December 2020. Importantly for the funds and financial services industry, UK-EU passporting will be able to continue during the transition. Also, EU law will continue to apply and new EU law will still be implemented in the UK.

30 June 2020 is the next pivotal date, being the deadline for deciding whether or not there is to be a one-off one or two year extension of the transition period (although the UK government's intention is that there will be no extension); and also by which time the EU and the UK have agreed that they will endeavour to complete equivalence assessments. If nothing is agreed in time, then the no deal Brexit outcomes will crystallise at the end of the transition period. Subject to activation of temporary reciprocal access arrangements between the UK and EU27, firms will be relying on their contingency planning in order to achieve continued market access and business continuity. The Financial Services Contracts Regime could also enable EEA firms to continue servicing UK contracts entered into prior to exit day for a limited period.

Many cross-border activities of third country firms, specifically delegation and marketing, require regulatory co-operation agreements to be put in place. In the absence of these co-operation agreements, UK managers would not be permitted to act as delegated portfolio managers of EU AIFs (a central plank of many contingency plans) or register for marketing into EU27 member states under the Article 42 NPPRs. Memoranda of Understanding (MoU) between the FCA, ESMA and EU regulators to allow co-operation and exchange of information have been agreed and are expected to be in place in time for 31 December in the event of a hard Brexit.

Action point: The FCA's expectation, as stated in its Dear CEO January 2020 letters, is that firms consider how the end of the implementation period will affect you and your customers, and what action you may need to take to be ready for 1 January 2021. Fund managers will want to continue to check back against their contingency plans to assess whether developments change their approach. Note that the MoUs need to be in place on an individual jurisdiction by jurisdiction basis, so managers also need to check whether particular member states where they are performing marketing are expected to sign-up to them in time.

Sustainable finance initiatives and long-term value

There is strong political drive for responsible and sustainable business conduct – in the UK, EU-wide and globally. The UK backdrop, alongside various industry-led initiatives, includes the FCA's support for introducing climate-related mandatory disclosure requirements for regulated firms (as set out in its October 2019 Feedback Statement on Climate Change and Green Finance), and the Department for Work and Pensions' recommendation that pension scheme trustees prepare an optional policy on how investment strategies consider non-financial factors, such as ethics, social and environmental impact, and quality of life.

In November 2019 the EU adopted a package of measures on sustainable finance, coming into force from 10 March 2021. The reform's key tenets are taxonomy, disclosure, investor duties, benchmarks and suitability. Asset managers will be required to integrate sustainability risks into their operating models, provide more detailed disclosures on ESG (environmental, social and governmental) policies and sustainability risks and increase due diligence on the ESG profile of funds.

This legislation has a much shorter implementation period than most other EU financial services legislation, with affected firms only having 15 months to become compliant (with a delay until January 2022 for the first annual reports containing ESG/sustainability information). Given this short window firms will need to begin their implementation planning early in 2020. Further, as EU delegated legislation is expected to impact MiFID II and IDD suitability testing, firms should also be prepared to take ESG considerations and preferences into account in the suitability assessments they undertake to see if proposed investments are appropriate for a client.

A growing number of investors and managers are signatories to the UN Principles for Responsible Investment. This involves a manager's commitment to six voluntary and aspirational investment principles, including: considering ESG issues when making investment decisions; seeking disclosures from ESG entities in which they invest; and reporting on ESG activities. Another framework likely to gain more recognition in the funds industry is the UN's Sustainable Development Goals (SDG) Impact Practice Standards for Private Equity Funds, a checklist designed to integrate impact into fund design and execution. Reportedly, the US SEC's examination branch, the Office of Compliance Inspections and Examinations, has started scrutinising investment advisers to ensure that they are in fact managing their client funds in accordance with their stated ESG strategy.

Side letter provisions are becoming more common, for instance that the manager maintains and/or introduces appropriate ESG strategies to the management of portfolio investments.

Action point: We are seeing sustainability becoming more central to managers' and investors' considerations. 2020 will be a crucial year for asset managers to codify and embed the EU sustainable finance measures, alongside similar initiatives emanating from the UK and other jurisdictions, into their operating, legal and governance approaches.

NRCGT: deadlines approaching to make elections for non-resident property gains

Fund managers will be familiar with the 6 April 2019 introduction of a tax charge on capital growth in a UK property investment for non-UK residents. This new tax charge on capital gains applies where a non-resident investor is selling the UK property directly (a "direct disposal") or indirectly through the sale of an interest in a "UK property-rich" vehicle (an "indirect disposal"). A vehicle is "UK property-rich" if it derives, directly or indirectly, at least 75% of its value from UK property. Generally, the charge does not apply to an indirect disposal where the investor has held less than 25% of the vehicle throughout the two years before the disposal, but this 25% exemption does not usually apply to funds. Existing exemptions apply, for example for certain pension funds and sovereign wealth funds.

As a result of the Government's extensive engagement with the funds industry, the legislation broadly preserves the status quo for indirect investment in UK real estate, in particular the efficiency of JPUTs that meet certain qualifying conditions and make appropriate elections. By making elections available care has been taken to try to avoid multiple layers of taxation in a fund structure and to not adversely affect exempt investors. Without the elections a fund other than a partnership could have a tax charge if it disposes of UK land directly or indirectly. The elections are the transparency and exemption elections. Funds should be aware that deadlines for making the elections could be as early as 5 April 2020.

The transparency election allows offshore funds that are "UK property-rich" which are transparent for income (eg JPUTs and FCPs) to elect to be transparent for capital gains. Such funds generally have to make an election within 12 months of first acquiring an interest in either UK land or a "UK property-rich" vehicle. However, funds that had made their first acquisition before 6 April 2019 have a right to make a transparency election at any time up to 5 April 2020. This deadline for pre-existing funds approaches. A fund needs consent from its investors to make the election, so this should be factored into the timeline for obtaining any such election. Because of the investor consent requirement, this election is likely to be practical for narrowly-held funds. The election is irrevocable.

The conditions for making the exemption election are harder to satisfy. Essentially it is likely to be applicable only to widely-held or marketed offshore funds or funds with significant investment from certain institutional investors. The exemption election has the effect of exempting the fund from a tax charge under the new rules and provides a proportionate exemption for a gain incurred by an entity in which the fund has at least a 40% investment. The exemption election is also available in respect of certain companies wholly-owned (or almost wholly-owned) by partnerships or CoACS. If the exemption election is made, there are onerous compliance obligations. In general, an exemption election can only be back-dated by 12 months (though HMRC may "give consent in specific cases" for a longer look-back period). The deadline of 5 April 2020 is approaching for any funds that made disposals immediately after the new regime was introduced on 6 April 2019 to be covered by elections back-dated by 12 months.

Action point: Many fund managers and investors in UK real estate are having to re-visit their fund structures and holdings, consider possible elections/alternatives, as well as understanding practical considerations in order to implement chosen plans. See our November 2018 briefing for more. Fund managers should check whether any elections that need to be made by 5 April 2020 have been made.

DAC 6: greater transparency of arrangements with tax authorities

DAC 6 is an EU Directive (Directive 2018/822) requiring disclosure of reportable cross-border arrangements to the relevant EU Tax Authority. Although it does not come into force until 1 July 2020, it has a retrospective element requiring reporting of arrangements where the first step was implemented on or after 25 June 2018. Notwithstanding Brexit, the measure has now been adopted into UK law through final UK regulations and with (very) limited guidance from HMRC. HMRC has indicated it will provide fuller public guidance by June 2020. Most of the other EU jurisdictions have also implemented the regime domestically.

The regime requires reporting of cross-border arrangements which fall within certain hallmarks. Whilst some of the hallmarks capture specified types of transactions that meet a tax main benefit test, not all do. Some hallmarks capture purely commercial arrangements. Cross-border is widely drafted, but has to involve at least one EU member state. The other jurisdiction involved need not be an EU member state.

The burden of reporting will fall primarily on intermediaries with an EU connection involved with the arrangement or, in the absence of an intermediary reporting the arrangement, the relevant taxpayer. Intermediaries may include not only the designer of the arrangement but also persons who market the arrangement or aid and assist its implementation. Lawyers and accountants as well as others may be caught. The reports go to the relevant EU tax authority, which will then exchange the information with other EU tax authorities.

Once the regime becomes live (for arrangements first made available or where the first step was implemented on or after 1 July 2020 (whichever is earlier)) there will be only 30 days to make the report. Although 'live' reporting does not start until July 2020, the regime also requires reports to be submitted by 31 August 2020 of transactions that were first implemented from 25 June 2018. In the UK there are two months (July and August 2020) to submit an online report of such retrospective transactions. However, the absence of thorough guidance in the UK until June 2020 on both the scope of the regime and compliance aspects makes this retrospective reporting challenging.

Action point: Funds should be considering how the regime is likely to impact on them and the types of transactions they are involved with that could be within scope. It is possible that tax authorities may treat a fund and/or the fund manager itself as an intermediary and it will have primary reporting obligation. Where it is not an intermediary, it may be a taxpayer whose arrangement will be reported. In either event, it should review cross-border transactions where the first step was implemented on or after 25 June 2018 to assess its reporting obligations for the retrospective transactions bearing in mind the reporting deadline of 31 August 2020. It should also assess how it will deal with the 30 day reporting window for transactions first made available or implemented from 1 July 2020. Because cross-border arrangement is defined widely, this may include a restructuring of an existing fund or a fresh capital raise for such a fund. It is possible in some cases for an intermediary to rely upon the reporting of another intermediary, but it needs evidence that the other intermediary has reported the same information it would otherwise be obliged to report. HMRC will issue further guidance on "reliance" in due course.

VAT recovery for GPs that are VAT-grouped with managers in onshore investment fund structures

In the recent case of *Melford Capital General Partner Ltd v HMRC*, the First-tier Tax Tribunal (FTT) concluded that a UK GP was entitled to full recovery of input VAT incurred on the establishment and operational costs of a UK limited partnership of which it was the general partner.

The key facts were as follows:

→ the GP was VAT-grouped with the UK manager (an LLP);

→ the fund funded a holding company (with interest free loans and by subscribing for shares);

→ the holding company in turn funded SPVs, which held UK commercial properties which were opted to tax;

→ the LLP supplied management and administrative services to the fund and also directly to the holding company and SPVs; and

→ the LLP charged the recipients for such services.

Following HMRC guidance, the GP was regarded as carrying on the fund's business for VAT purposes.

The taxpayer argued that the VAT group should be treated as a single person which raised capital from investors and invested in the fund assets with a view to supplying management services to the GP and the SPVs. On that basis, the VAT group should be entitled fully to recover the VAT incurred on the costs of establishing the fund and the ongoing costs of managing the GP because the VAT group was making fully taxable outbound supplies.

By contrast, HMRC argued that the correct approach was to analyse the nature of the costs incurred and whether they were components of the outbound taxable supplies, rather than the status of the taxpayer as a member of the VAT group. HMRC argued that the group engaged in some non-economic activities to which the costs related, and that accordingly the group's recovery of input tax should be restricted.

The FTT agreed with the taxpayer's analysis and held that the GP was entitled to fully recover the input VAT incurred.

Practical implications:

→ HMRC is likely to appeal the FTT's decision. It may take years for the issue to be resolved through the courts.

→ In the meantime, businesses who have an identical or similar structure should consider making a protective claim for recovery of input VAT incurred which has been disallowed during the last 4 years.

→ This would be a "protective" claim because HMRC are unlikely to make pay-outs until the issue is finally resolved.

→ If and when the matter is resolved in favour of the taxpayer, the 4 years will date back from the date of the protective claim, rather than from the date of the final court decision.

→ There may be structuring opportunities to increase VAT recovery for funds currently operating without a VAT group by applying to VAT group.

Other anticipated developments to look out for in 2020

UKLP reform

Following the December 2018 Government response to its consultation (which closed in July 2018) on the reform of limited partnership law (the major elements of which, along with our comments, are set out in our briefing Welcome Government response to UK limited partnership law reform consultation) we still await draft legislation and further detail in some areas. Of particular interest will be the procedure introduced for striking off UKLPs from the Companies House register, along with transitional provisions for existing UKLPs relating to the new mandatory requirement for UKLPs to retain a demonstrable link with the UK.

Further progress is expected in 2020.

Corporate transparency and reform of the companies register

The government is likely to publish a formal response in 2020 indicating its next steps in relation to the BEIS consultation (published in May 2019 and which closed on 5 August 2019) on proposals to enhance the role of Companies House, increase the transparency of UK corporate entities and help combat economic crime. Examples of proposals include: verification of the identity of directors, collection of more detailed information on shareholders and capping the number of directorships that an individual can hold. Implementation of any reform is likely to take several years and industry engagement will be essential, in order to proactively deal with any likely complexities on practical implementation.

Overseas Entities Bill

Following a Government consultation (along with draft legislation, published in July 2018) we are expecting a final draft of the Overseas Entities Bill, which is due to go live in 2021. The draft legislation provides that non-UK entities that are legal persons (so including non-UK companies and LLPs, and non-UK partnerships that have or elect to have legal personality) will have to identify and provide information on those with significant influence or control over them, before they can be registered as legal owners of UK real estate or register legal charges at the Land Registry. As per the 'persons with significant control' (PSC) rules, failure to comply is a criminal offence. An overseas entity that is within scope and that cannot provide beneficial ownership information must provide information about its managing officers.

Action point: Overseas investors who own, or are proposing to acquire, UK property, will want to plan ahead for registration, by identifying both UK property holdings to which the new regime may apply and the registrable beneficial owners. Ensuring that the large number of international owners of UK high value (often residential) property are both aware of these new rules, and complete the registrations, may take some time. The loss of personal confidentiality is also likely to be unwelcome.

AIFMD review

The roadmap of "AIFMD II" is expected in Q2 2020 – that is, the European Commission (the Commission)'s wider review under Article 69 AIFMD, to culminate in a report to the European Parliament and Council. The likely pointers for any hypothetical future revisions are from amongst the findings of the January 2019 KPMG report. Broadly, this found that AIFMD is mostly working as intended but that: (i) it suffers from uneven interpretation and implementation across the EU; and (ii) many of the disclosure requirements are excessive and duplicative. The previous Commission's focus on the Capital Markets Union and Sustainable Finance may have made some inroads into the reported divergences. The report acknowledged that the asset management industry continues to be impacted by a swathe of new rules and by regulatory uncertainty. In this context the European legislature could decide that adding to that already considerable burden would not be welcome and could cause yet more disruption and costs for investors, the industry and regulators.

See our briefing Effectiveness and Efficiency of AIFMD Under Scrutiny for the principal points of interest arising from the report, both positive and constructive.

Real estate funds market overview and observations

Real estate as an asset class has continued to gain favour since the financial crisis, with target allocations by institutional investors reported to be at a seven year high of 10.5% in 2019 (Hodes Weill 2019 Institutional Real Estate Allocations Monitor). €88.5bn of capital is earmarked for European real estate investment in 2020, according to the INREV investment intentions survey 2020 (rising from €60.7bn in 2019). ESMA's annual report on the EU AIF market recorded high growth in real estate funds, accounting for 12% of the NAV of AIFs, at €730bn (increasing by 35% in 2018) and the third largest AIF type. Despite running themes of Brexit disruption, market uncertainty and scarcity of product, the historic low correlation of private equity real estate with traditional equity markets, means that an investment in a private real estate fund has continued appeal – it could help diversify an investor's portfolio, reduce overall portfolio risk and increase returns.

Investors continue to access the asset class via allocations to funds, joint ventures and clubs as well as separate accounts and direct investment. INREV identified recent shifts in trends in its 2020 survey: funds being the most likely route that investors will access European markets; investors shifting up the risk curve towards opportunistic at the expense of value add strategies and anticipated growth in real estate debt. More capital is moving into alternatives such as student accommodation, healthcare, senior living and operationally intensive real estate. However, capital remains unevenly concentrated (the Hodes Weill 2019 Monitor found that 53% of the capital raised in Q3 2019 was placed with the 10 largest funds, compared to 37% for the same period in 2018) which reflects what we have been seeing in the market - investors increasing their allocations to favoured and well-established managers, resulting in fewer but larger fundraises. Alongside this significant discretionary and non-discretionary co-investment allocations remain prevalent.

Other familiar themes which we continue to see include: a growing interest in long-dated funds or 'permanent capital vehicles' (with terms of 15 years or more); strategic investors continuing to look for opportunities to invest into the GP or sponsor alongside the fund investment; ongoing competition to place capital and source investment opportunities; and strong interest in European real estate from Asia-Pacific investors.

ILPA's model limited partnership agreement (LPA) conforms to ILPA Principles 3.0 (both published in 2019), and is part of ILPA's Simplification Initiative, designed to streamline the negotiation process and reduce fund formation costs. Time will tell as to whether or not the Model LPA is likely to emerge as the manager roadmap to attract LP capital and establish best practices, or instead becomes a useful benchmarking/reference point of investor representations in private funds. In either case, the industry should carefully consider the pro forma, alongside Principles 3.0, and be prepared for a healthy dialogue between investors and promoters during the fundraise and over the life of the fund.

We have provided a sample of those ILPA Model LPA provisions that we believe will be of interest to fund managers, sponsors and investors, along with our comments, based on recent fundraisings that we've been involved with. Please see the table on the next page.

ILPA Model LPA provisions

Model ILPA LPA	Our Comments
ILPA wants fiduciary duties of GPs to LPs under the relevant legal and regulatory framework to be expressly reinforced in fund documents, namely the obligation of the GP to put the interests of the fund as whole before that of a subset of investors or the GP itself. Also, the indemnity provision in the ILPA Model LPA (that protects the GP from third party claims) excludes protection in the event of the GP's contractual breach, including for any side letters it enters into, or behaviour that constitutes "gross negligence, fraud or wilful misconduct."	An example of a particularly investor-focussed provision that expressly reinforces the GP's duties in fund documents. A consequence could be that material breach by the GP of this express standard of care constitutes Cause removal conduct and loss of the fund indemnity protection. Excluding the GP indemnity for conduct constituting any breach of the fund documents is atypical, and in our experience it would be more common for the GP to lose the indemnity protection in cases of material breach.
The Model LPA features a whole fund carried interest calculation (ie the European standard all-contributions-plus-preferred-return-back-first model) with illustrative typical market terms for a large closed-ended value added or opportunistic fund - being a management fee (unspecified in the Model LPA, but typically 1-2%), 20% carry, 8% hurdle and 80:20 GP catch-up arrangement. ILPA is due to produce a deal-by-deal waterfall model (the market standard approach for North American funds).	Although catch-up mechanisms, carried interest clawback, and post-investment period step-downs in management fees are now established market norms, the Model LPA terms move the pendulum further in favour of LPs. For instance, an escrow provision (albeit optional) as well as a GP clawback that is triggered both on specific interim events and on fund liquidation, mean that a GP may not receive any carried interest until close to the end of the term of the fund.
No management fee is payable during the liquidation period, any extensions to the fund's term or any key person suspension period.	This latter approach in particular could prove problematic because a lack of fee income would hamper a GP's ability to hire an appropriate replacement key person. Also, the suspension during winding up seems harsh when applied to some strategies, such as real asset funds, where illiquid assets may take time to realise.
For carried interest calculations where a credit facility is in place, the preferred return should accrue from the date that capital is at risk, ie when the credit facility is drawn, instead of when the capital is ultimately called from the LPs.	This reiterates what is stated in ILPA Principles 3.0, as is also set out in the June 2017 ILPA guidance on Subscription Lines of Credit. However, this continues to be an area which may be challenging for GPs to support.
If removed for Cause, the Model LPA provides that carried interest payments cease, and escrow amounts are to be returned to the fund. On removal without Cause, the Model LPA provides the option for an automatic reduction of carried interest for investments made before removal (and that the GP will not receive any carry in respect of any investment made after the removal date), subject to GP co-operation and with the clawback provisions continuing to apply.	Although this approach reflects a 'fair' result that the exiting GP on a removal without Cause receives a (presumably) sizeable share of the carry from existing investments, it does not reflect a distinction which often comes up in practice between 'cause' (eg material, unremedied breaches with detrimental effect) and 'bad acts' (eg court decision for fraud or dishonesty); where the carry consequences for removal due to a 'bad act' are more severe.
All side letter provisions must be disclosed to all investors and the MFN provision is included in the LPA. The MFN right is not size-based, has limited exceptions, and operates automatically (ie without elections required by investors).	In our experience it is more common for side letters to be disclosed to investors unless that investor has made a lower commitment. We also typically see an election process, with various and more generous carve outs than those contemplated by ILPA.

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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