

## Asset Management Group

# Key issues for asset managers in 2014

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### **SPEED READ**

Asset managers continue to face significant regulatory challenges and 2014 marks the first full year of operation for many new regulations. The impact of these new regulations is substantial and will cause upheaval and change in the sector. Asset managers competing in an increasingly global sector will need to take into account the increasingly international (and often competing) nature of regulatory developments in their key target markets.

Allen & Overy's Asset Management Group has summarised some of the key Asia-Pacific, European, U.S. and tax developments that will impact asset managers, looking at the policy behind each, timelines for its implementation, business models in scope and, most importantly, the potential impact on your business. Links to more detail are included in each section.

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# Contents

## U.S.

Dodd-Frank Act – Designation of asset managers as systemically important financial institutions 3

---

Volcker Rule finalised with a more limited application to covered fund activities 5

---

## Asia-Pacific

The Asian Region Funds Passport – one step closer to reality 8

---

The Feeling’s Mutual – Development in Hong Kong/PRC funds recognition 9

---

## Europe

Alternative Investment Fund Managers Directive – Implications for depositaries of Illiquid Asset Funds: who wants to be a depositary? 10

---

The Luxembourg perspective on the “Letter Box” 16

---

UK FCA Thematic Reviews 18

---

## Tax

Tax highlights for asset managers 20

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# Dodd-Frank Act – Designation of asset managers as systemically important financial institutions

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## What is the policy?

As we reported in [last year's issue](#), the U.S. Financial Stability Oversight Council (**FSOC**) has the ability to designate as Systemically Important Financial Institutions (**SIFIs**) non-bank domestic or foreign companies that are predominantly engaged in financial activities in the U.S. (such entities, **Non-Bank SIFIs**). Companies that are designated as SIFIs are subject to enhanced oversight and regulation by the Federal Reserve Board (the **Federal Reserve**). These requirements include among others: enhanced prudential standards and early remediation; living will requirements; being subject to the U.S. Dodd-Frank Act's orderly liquidation authority; Volcker Rule implications; increased examination and enforcement; and increased administrative, reporting and recordkeeping requirements.

## General developments in 2013 – 2014

In June 2013, FSOC voted to propose the designation of American International Group, Inc. (**AIG**), Prudential Financial, Inc. (**Prudential**), and GE's financial arm, General Electric Capital Corporation (**GE Capital**), as the first three Non-Bank SIFIs. Prudential objected to its proposed designation, but FSOC ultimately confirmed its decision. Prudential did not seek judicial review. Metlife Inc. (**Metlife**) also disclosed in 2013 that FSOC had reached the final stage of the SIFI preliminary designation process, but neither Metlife nor FSOC has made further public announcements. Similarly, FSOC has begun scrutinizing Berkshire Hathaway Inc. (**Berkshire Hathaway**) to determine whether the reinsurer is systemically important, though any decision on Berkshire Hathaway's potential status as a SIFI would be months away. In addition, the Federal Reserve

proposed rules in December 2012 for enhanced prudential standards for non-U.S. SIFIs (including Non-Bank SIFIs), although the Federal Reserve has yet to adopt final rules. The proposed rules would significantly reduce the flexibility that non-U.S. banks have traditionally enjoyed in structuring their U.S. banking and financial operations by imposing capital, liquidity, stress testing and other requirements on a non-U.S. bank's U.S. operations.

## Specific developments related to asset managers

In a move of significant importance to the asset management industry, FSOC determined in November 2013 to study U.S. asset managers Fidelity Investments (**Fidelity**) and BlackRock Inc. (**BlackRock**) for potential Non-Bank SIFI designation; as of the date of this article, FSOC remains in the initial stage of review for both firms. FSOC's decision to study Fidelity and BlackRock came on the heels of the U.S. Treasury's Office of Financial Reform (**OFR**) report on Asset Management and Financial Stability (the **Report**), published in September 2013 and conducted at the request of FSOC to inform its analysis when considering the designation asset managers as Non-Bank SIFIs. The Report concluded that certain practices by asset managers could present systemic risk to the financial markets; such practices include "herding" (concentrating investments in certain asset classes), responding to frequent or large-scale redemption requests, and engaging in "fire sales" of assets in a liquidity crunch.

In an unusual procedural move, on the day it was issued, the U.S. Securities and Exchange Commission (**SEC**)

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invited public comment on the Report. Over 30 interested parties submitted comments, which expressed almost universal disagreement with the Report, its analysis and its findings, and strenuously encouraged FSOC not to rely on the Report's findings in determining whether to designate an asset management firm as a SIFI. Respondents included Fidelity, BlackRock, The Vanguard Group Inc., Fitch Ratings, the Securities Industry and Financial Markets Association (**SIFMA**) and the U.S. Investment Company Institute (**ICD**). Respondents contended that the Report failed materially to demonstrate: (i) an understanding of the asset management industry; (ii) how asset management activities pose a systemic risk to U.S. financial markets; and (iii) how SIFI designation and prudential regulation of asset managers could effectively mitigate such risk. The industry's concerns were voiced earlier by at least one SEC Commissioner; in a February 2013 speech, Commissioner Daniel Gallagher called FSOC an "institutionalized mechanism for one set of regulators to pressure another in the [SEC's] field of expertise". It remains to be seen whether FSOC will ultimately designate Fidelity, BlackRock or any other asset manager as an SIFI and how the SEC would respond if FSOC were to recommend to the SEC that it apply heightened standards and safeguards to asset management firms generally.

On January 8, 2014, the Financial Stability Board (**FSB**) and the International Organization of Securities Commissions released a thoughtful consultation paper setting out proposed assessment methodologies for identifying non-bank, non-insurance company global-SIFIs, potentially extending the current framework for enhanced supervision of globally significant banks and insurers to other types of financial institutions, including asset managers and investment companies. The consultation paper does not propose any specific entities for designation, nor any policy measures that would apply to such SIFIs, but it does indicate a continued coordinated effort to extend enhanced supervision to non-depository institutions that are deemed to play major roles in financial markets. We do not view the FSB's consultation paper as endorsing any conclusions of the OFR or FSOC, but the paper indicates

the FSB's willingness to consider non-bank, non-insurance companies for enhanced supervision.

## What does it mean for your business?

While FSOC's approach in determining whether Fidelity or BlackRock (or any other asset manager) should be designated as a SIFI, as well as the details of a final SIFI designation of an asset manager, remain unclear, it is significant that FSOC undertook its initiation of a study of asset managers in the face of heavy industry objection to the OFR Report and that FSB appears to be prepared to follow suit in some manner. As a result, U.S. and non-U.S. asset managers should pay careful attention to FSOC's actions and the responses by the SEC and by asset management firms that face FSOC scrutiny. With respect to the Federal Reserve's enhanced supervision of non-U.S. SIFIs, any final rule will likely be similar to the proposed rule and closely follow the rules for U.S. SIFIs. While it remains uncertain whether non-U.S. asset managers will be targeted by FSOC for SIFI designation, such managers should follow closely the developments concerning SIFI designation of U.S. asset managers for guidance.

## Read more

We previously prepared a client bulletin that goes into significant detail as to the rule proposal for applying enhanced prudential standards to non-U.S. SIFIs:

[Fortress America: The Federal Reserve's proposal to impose U.S. territorial restrictions on large foreign banks](#)

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# Volcker Rule finalised with a more limited application to covered fund activities

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## What is the policy?

We reported in [last year's issue](#) that the so-called "Volcker Rule", which would implement the requirements of Section 619 of the U.S. Dodd-Frank Act, had been proposed in 2011 by five federal agencies and included provisions designed to restrict a banking entity and its affiliates from engaging in certain activities or roles in respect of "covered funds" and from undertaking (as principal) proprietary trading activities. The agencies adopted the final Volcker Rule on 10 December 2013 following a rulemaking process that lasted over two years and took into account thousands of comment letters from industry participants. Although the general policy directive behind the final and proposed version of the Volcker Rule remained unchanged, significant changes in the final version of the rule, and in the agencies' guidance with respect to the rule, now provide more flexibility for banks to structure investment vehicles to avoid covered fund status and relax many of the rule's restrictions on non-U.S. banks' activities. While the Volcker Rule contains restrictions on a bank's ability to engage in proprietary trading and to sponsor and own covered funds, the discussion below focuses on the covered funds elements of the Volcker Rule, which generally are the most relevant aspects of the rule for asset managers.

## What are the significant changes in the final Volcker Rule as compared to the proposed Volcker Rule?

The covered funds restrictions, found in Section 10 of the Volcker Rule, are now more limited with respect to bank

sponsorship of and investment in covered funds, particularly for non-U.S. banks' activities with respect to non-U.S. funds. As an initial matter, the final Volcker Rule reduces the scope of the definition of covered fund in several ways, including: (1) limiting the types of commodity pools that are covered funds by definition; (2) providing new exclusions from the definition for certain types of vehicles, including "retail" funds publicly offered outside the U.S., covered bond entities, asset-backed commercial paper conduits, and other vehicles; and (3) specifically excluding from the definition many of the entities, such as loan securitizations, wholly owned subsidiaries, joint ventures and other vehicles that under the proposed rule a bank would have been permitted to sponsor and own subject to severe restrictions.

Specifically with respect to a non-U.S. bank, non-U.S. investment vehicles (but not commodity pools) that do not offer their interests in the U.S. or to U.S. persons are now excluded as covered funds (a non-U.S. bank for this purposes generally means a bank that is not organised or located in the United States and is not controlled by a bank that is organised or located in the U.S.). This recognition of the limitations of the Volcker Rule's extraterritorial application thus should exclude from the Volcker Rule a large portion of the fund and securitisation businesses for many non-U.S. banks involved in the asset management industry and significantly benefits non-U.S. banks that, under the proposed rule, would have been required to treat such funds as "foreign equivalent" funds, a category of covered funds under the proposed rule. The agencies' welcome approach also eliminates the need for a non-

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U.S. bank to determine, as a threshold matter, which exemption from registration under the U.S. Investment Company Act of 1940 (the 1940 Act) applies to a vehicle, which under the proposed rule was the only way to avoid covered fund status for securities funds (versus commodity pools).

The overhaul of the definition of covered fund results in two significant outcomes for banks with respect to investment vehicles no longer included within the definition or specifically excluded from the definition, both highly positive. First, a bank and its affiliates now may invest in or sponsor, free from restriction, vehicles that under the proposed rule required a very restrictive conditional permitted activity exemption, and second, a bank and its affiliates may engage with such vehicles in the types of transactions otherwise prohibited by Section 23A of the U.S. Federal Reserve Act (known as “Super 23A Transactions” for Volcker Rule purposes). Super 23A Transactions include lending to a vehicle and entering into a derivative transaction that results in credit exposure to the vehicle, which often times a bank may routinely enter into with investment and securitisation vehicles.

## **Does the Volcker Rule apply to your business?**

As was the case in the proposed rule, the final Volcker Rule applies to any “banking entity” which is defined to include insured depository institutions (and their controlling companies), companies treated as bank holding companies for the purposes of the U.S. International Banking Act of 1978 and, with respect to each of the foregoing, *any affiliates and subsidiaries*. Companies treated as bank holding companies for these purposes will include non-U.S. banking organisations with branches or agencies in the U.S. As a result, non-U.S. banking organisations will generally be within this scope if they have a U.S. presence (which will be the usual position for most large banking groups). Because the Volcker Rule defines “banking entity” so broadly, its provisions will apply to the asset management arm of any bank that is subject to oversight by the U.S. Federal Reserve Board due to a branch or agency in the U.S..

## **What will it mean for your business?**

If the Volcker Rule applies specifically to your asset management business, you should review the investment vehicles you manage, sponsor or invest in to determine whether your activities with respect to those vehicles will be subject to the Volcker Rule’s restrictions. We describe a framework for analysing a vehicle’s status as a covered fund in a recent e-Alert: [Non-U.S. Banks Under The Volcker Rule: A Framework For Analyzing Covered Fund Status](#). We have also prepared an FAQ for non-U.S. banks specifically involved in sponsoring and investing in securitisation vehicles outside of the United States: [U.S. Volcker Rule – Covered Funds: FAQs for European structured finance transactions](#).

An investment vehicle that either cannot avoid falling within the definition of “covered fund” or fails to meet an applicable exclusion from that definition will be a covered fund. Banks are permitted to own and sponsor covered funds on a very limited and conditional basis under certain permitted activity and other exemptions, which include an asset management exemption, an exemption for acting as the securitiser of certain Asset Backed Securities (ABS) transactions, an exemption for underwriting and market making activity, and, with respect to non-U.S. banks, an exemption for the bank’s activities with respect to non-U.S. commodity pools that are covered funds. The exemptions require a bank to curtail certain activities, limit the amount the bank may invest in a covered fund and, most notably, prohibit Super 23A Transactions for banks that sponsor or organise and offer a covered fund.

Asset managers not affiliated with a bank and thus not subject to the Volcker Rule may nonetheless feel the effects of the rule. No bank subject to the Volcker Rule will be permitted to invest in funds relying on Section 3(c)(1) or 3(c)(7) of the 1940 Act, and such banks may request an asset manager to provide alternative structuring or management solutions in order to allow the bank to retain or make investments in such funds. Non-U.S. banks, in particular, may request a manager to establish a parallel non-U.S. fund in which the bank will invest so as to avoid the prohibitions of the Volcker Rule. We have addressed these issues for non-bank asset managers in greater detail in a recent client bulletin:

[Asset Managers - The Volcker Rule’s Relevance](#).

## **When does it come into effect and what is going to happen before it does?**

The Volcker Rule takes effect on 1 April 2014, and does not provide for grandfathering with respect to existing banking operations. The agencies extended the conformance period for compliance until 21 July 2015, at which time full compliance with the Volcker Rule is required, although U.S. regulators have made clear, in extending the conformance period, that banking entities must engage in good faith efforts to conform their activities to the Volcker Rule's requirements during the conformance period and should not expand their activities and make investments with an expectation that the conformance period will be extended. As a practical matter, this means that banking entities should begin immediately to take steps to come into compliance with the Volcker Rule. Additionally, banking entities with consolidated trading assets and liabilities of USD50 billion or more will be required to report

quantitative measurements beginning 30 June 2014; those of USD25 billion or more will be required to report beginning 30 April 2016; and those of USD10 billion or more will be required to report beginning 31 December 2016.

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# The Asian Region Funds Passport – one step closer to reality

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Australia's fund management industry welcomes the Asian Region Funds Passport pilot programme in Australia. The Australian Finance Minister, as well as other Asia Pacific Economic Cooperation (APEC) economies including New Zealand, Singapore and South Korea (Signatories), signed a Statement of Intent (SOI) on 20 September 2013 to launch the Asian Region Funds Passport and publicly consult on the detailed rules for its implementation which is scheduled to begin early in 2016.

The Asian Region Funds Passport is a new regional collective investment vehicle framework. It resembles the European Union's UCITS Directive which, over time, has developed into a *de facto* standard to allow European fund managers to gain access to Asia's savings through cross-border distribution of funds and funds management services. The success of the UCITS Directive as a European platform increased the desire to establish multilateral arrangements to allow cross-border offering of collective investment schemes in the Asia Pacific region.

If the Asian Region Funds Passport is successful, Australian investors will have the opportunity to access nearly AUD3 trillion in managed funds across the APEC economies, generating substantial economic growth and financial services exports to the Asian region, as well as creating competition among EU and Australian fund managers. The Asian Region Funds Passport aims to provide investors with a more diverse range of investment opportunities enabling them to better manage their portfolios and grow the pool of funds available for investment in the region.

The SOI includes a timeline for implementation as well as a framework document outlining how the Asian Region Funds Passport should operate. According to the SOI, the Signatories are to conduct public consultations from January 2014 to June 2014 on the technical and procedural rules of the Asian Region Funds Passport's

implementation. The framework document specifies generally that:

- host economy (ie where a Passport fund is offered outside its home economy) laws will apply where they relate to the direct interaction between investors and the Passport funds (ie distribution, disclosure, complaints handling and marketing laws that apply to the host economy's local collective investment schemes);
- home economy (ie where a Passport fund is domiciled) laws will apply to the authorisation, registration, approval or licensing of the collective investment scheme and its operator, directors, and officers; and
- home economy laws will apply to outsourcing service providers, risk management requirements and meetings of Passport funds members.

The Signatories agree to recognise and respect each other's regulatory frameworks to ensure the integrity of the Asian Region Funds Passport and its operation in a fair, efficient and transparent financial market. This is particularly important as the framework document provides that a host economy may impose additional rules within specified areas of practice on Passport funds offered in their jurisdiction. The rules must be mutually determined, reasonable and not unduly burdensome in comparison to local collective investment scheme rules.

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# The Feeling's Mutual – Development in Hong Kong/PRC funds recognition

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The proposed mutual recognition of funds in Hong Kong and the Mainland China is gathering pace. At the HKIFA 7th Annual Conference on 4 December 2013, various speakers from Hong Kong's Securities and Futures Commission (SFC) and the China Securities Regulatory Commission confirmed that the rules for the mutual recognition of funds sold in Hong Kong and Mainland China will be released "soon". One of the major benefits of the "mutual recognition" status is that it will allow funds that are authorised in Hong Kong to be distributed in Mainland China under a streamlined authorisation process. This would open up significant opportunities for international fund managers and product issuers to distribute their funds in Mainland China. The same applies to Mainland Chinese fund managers and product issuers looking to attract international investors via the internationally recognised Hong Kong funds platform.

Trevor Lee, Director of Investment Products of the SFC, mentioned that the first batch of Hong Kong-authorized funds eligible for distribution in Mainland China under the mutual recognition programme would be those which satisfy certain specific criteria (yet to be finalised), but which would probably include:

- the requirement for the fund to be domiciled in Hong Kong (this would be a priority in an effort to turn Hong Kong towards the "manufacture" rather than mere distribution of funds);
- minimum capital requirement of RMB200 million;
- fund managers needing to have a proven track record; and
- plain vanilla funds.

With respect to issues such as Know Your Client/ Anti Money Laundering, distribution channels for the funds, etc, the regulators are currently in discussion on

how that may work, but it is likely that this would be subject to the local rules.

## Seizing the opportunity

### *Hong Kong*

We have recently received a growing number of queries regarding funds potentially "re-domiciling" to Hong Kong (in particular, traditional Cayman fund vehicles looking to "re-domicile" to Hong Kong) and fund managers and product issuers looking to establish funds in Hong Kong, all such initiatives being designed to take advantage of the mutual recognition changes. This trend is likely to intensify as details continue to emerge concerning the new regime.

### *Mainland China*

As for Mainland Chinese fund managers, the proposed mutual fund recognition of funds would "open the door" for Mainland Chinese fund managers by allowing their fund products unfettered access to international markets and investors through the Hong Kong distribution platform. It would be a golden opportunity for Mainland Chinese fund managers to participate directly in the global markets.

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# Alternative Investment Fund Managers Directive – Implications for depositaries of Illiquid Asset Funds: who wants to be a depositary?

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## Background

Until now, few private equity firms have used custodians or depositaries. They use fund administrators, often offshore, to perform a number of back office and investor liaison functions, which may also physically hold share certificates for their funds' investments, but few firms have felt the need for a full-blown custodian. The Alternative Investment Fund Managers Directive (**AIFMD**) is changing that. Many private equity, debt, real estate, infrastructure and similar alternative illiquid asset funds (**Illiquid Asset Funds**), the vast majority of which will be alternative investment funds under AIFMD (**AIFs**) will be required to have a depositary to be their custodian and provide other prescribed services.

This is an issue for fund managers and general partners who are characterised as alternative investment fund managers (**AIFMs**) under the AIFMD, as well as for the depositaries they appoint.

There are detailed requirements as to who can be depositary and what the depositary's responsibilities are, and these have major practical implications for many alternative fund managers. Some hedge funds will be subject to the same requirements, but they typically are familiar with using a custodian or prime broker providing custody services already and so, while there will certainly be changes for them, they will be less dramatic. This article focuses primarily on depositary issues under AIFMD affecting Illiquid Asset Funds.

This depositary requirement is only one of numerous new requirements AIFMs under AIFMD but this article only focuses on that one regime. [Please see our website](#) for other Allen & Overy materials deal with many other aspects of AIFMD.

The basic message here is that, for those funds where the depositary regime applies, to be a depositary even for a fund with custody needs as simple as an Illiquid Asset Fund with little trading in assets, significant systems infrastructure and significant legal, investment and valuation expertise is going to be needed to properly fulfil an AIFMD depositary's supervisory duties. There will need to be detailed on-going involvement in practice: it is not just a one-off repapering exercise. Each depositary caught by the regime will, subject to a special transitional regime until 2017, need a fully operational branch, duly authorised, in each country of establishment of the funds it acts for (or where the funds are non-EU, the home member state of their AIFMs). A carefully drafted depositary agreement is also going to be needed, as well as close cooperation on an on-going basis between the depositary and each AIFM who is required to ensure it performs its prescribed functions. Great care also needs to be taken where the depositary wishes to delegate or outsource certain functions especially as there is a strict liability regime for depositaries.

For some Illiquid Asset Funds, the depositary can, if the AIFM's home member state allows, be a professional firm that carries on depositary activity ancillary to its

professional business. However, even then, most of the depositary's duties described below still apply.

It is important to note that the requirements differ depending on where the AIFM manages the AIF from (ie, an **EEA AIFM** or a **Non-EEA AIFM**, where the AIF is (ie an **EEA AIF** or a **Non-EEA AIF**), which countries in the EEA the AIF is marketed in, implementation of AIFMD in each member state, and the transitional regime within AIFMD which brings the depositary requirements in on a phased basis with additional rules coming into force at a point between 2015 and 2018 yet to be determined (**Phase 2**). These factors will cause the regime to apply differently for some funds and some AIFMs compared to others.

## Basic requirements

Each AIFM is required to ensure that a single depositary is appointed for each fund (AIF) it manages, subject to certain exemptions and transitional reliefs depending on whether it is an EEA AIFM or Non-EEA AIFM, whether the fund is an EEA AIF or Non-EEA AIF, local implementation, and its position under the Phase 2 rules.

For EEA AIFMs, a depositary is required for any EEA AIF marketed in the EEA or managed from the EEA.

For EEA AIFMs marketing non-EEA AIFs in the EEA, a slightly lighter regime applies (if implemented by the relevant member state) whereby any person can be depositary provided it carries out safekeeping, cashflow monitoring and oversight functions for the AIF (the so-called **Depositary-Light Regime**), and indeed under the Depositary-Light Regime these functions can be split across multiple providers, although in Phase 2 this may change depending on whether the AIFM becomes authorised in the EEA (which may be necessary for it to continue marketing its AIFs in the EEA).

For non-EU AIFMs, a depositary is not needed until Phase 2, but then one is required for its EEA AIFs, and will be required where the AIFM becomes authorised in the EEA (which may be necessary for it to continue marketing its AIFs in the EEA).

The depositary must generally be an EEA bank or EU-authorised custodian, or, in the case of a non-EU fund, a non-EU depositary subject to equivalent

regulation and meeting a list of additional other requirements. For many Illiquid Asset Funds, it can also be an entity that:

- carries out depositary functions as part of its professional or business activities;
- is subject to mandatory professional registration recognised by law of statutorily prescribed rules of professional conduct; and
- can furnish financial and professional guarantees covering its function as depositary.

This latter category allows administrators and similar professional organisations to act as depositary for most Illiquid Asset Funds (but not other types of funds), provided they meet the other requirements for depositaries. In addition, this only applies to Illiquid Asset Funds which do not offer redemption rights during the first five years following first investment, or do not have as their core investment policy the investment in financial instruments (ie they invest in shares for the purposes of gaining control of a company).

An AIFM cannot be depositary for any AIF. Prime brokers cannot be depositary either, unless there is genuine separation on a functional and hierarchical level of the two activities of depositary and broker and all conflicts of interest are properly managed. Depositaries can, however, delegate certain of their custodian tasks to a prime broker. This latter requirement means that hedge funds' prime brokerage arrangements need careful thinking through.

For EU AIFs, the depositary must be established in the home Member State of the AIF (although there is a special transitional regime until 2017 for credit institutions anywhere in the EU, which individual member states can, but do not have to, opt into). "Established" is given a wide meaning to include "incorporated in" or "having a passported branch in".

For non-EU AIFs, the depositary will need to be established in:

- the third country where the AIF is established; or
- (if the AIFM is established in the EU) the home Member State of the AIFM; or

- (if the AIFM is established outside the EU but becomes authorised as an AIFM in the EU at a later stage), the Member State where it becomes authorised,

except that, until Phase 2, it can be any person (or persons) under the Depositary-Light Regime described above.

To be allowed a depositary in a third country, the third country must meet certain requirements regarding sharing of tax information, effectively enforced prudential regulation (including capital requirements and conduct of business requirements with respect to depositary activities) and cooperation with regulators in EU Member States.

The obligation to appoint an appropriate depositary, and carry out all the necessary diligence in doing so, is one which falls on the AIFM. However, this may be extended under national implementation - in the UK for example the rules are written to apply obligations directly on UK depositaries as well. It is possible for an AIFM to make one depositary appointment to cover all the AIFs it is AIFM for but this needs care because the specific responsibilities applicable for one fund may be different for others (see below) and so a “one-size-fits-all” style agreement may not suffice.

There are detailed content requirements for the depositary agreement, which must be with the relevant AIF or the AIFM on behalf of the AIF (or multiple AIFs).

Depositary agreements are going to require careful drafting as the AIFMD provisions are very prescriptive on a range of topics right across the Directive’s scope (not just in relation to AIFMD’s depositary provisions).

## Depositary duties

Depositaries’ duties break down broadly into three categories:

- cashflow monitoring;
- safekeeping duties; and
- oversight duties in relation to the AIFM and the AIF.

The cashflow monitoring duties extend to:

- making sure that all cash is booked to appropriately opened bank accounts for the AIF with appropriately

regulated banks (and only certain types of bank are permitted);

- ensuring that there are effective and proper reconciliation procedures for all the AIF’s cashflows and verifying reconciliations at appropriate intervals;
- ensuring at the end of each business day that significant cashflows can be identified, especially those inconsistent with the AIF’s operations;
- reviewing all procedures periodically and at least annually;
- monitoring the AIFM’s performance in remedying discrepancies arising from reconciliations and notifying the AIFM of any unresolved irregularities (and if not clarified by the AIFM notifying the regulator of the same);
- verifying cash positions of the fund against the depositary’s own records; and
- matching subscription proceeds from investors with information about investor subscriptions from the AIFM.

The practicalities of this are not to be underestimated. We have heard of some depositaries investing very significant time and effort with AIFMs, before the appointment is finalised, to ensure that the depositary and the AIFM systems can work in harmony, and that the depositary knows the AIF and the AIFM well enough as to be able to apply an appropriate level of diligence in carrying out its cashflow monitoring obligations. Without doing so, there could be significant liability for the depositary and the AIFM alike, and significant regulatory risk for both of them. This is particularly onerous where there are likely to be large and varied income cashflows from the fund. What is an appropriate level of diligence and when an issue should reasonably have been spotted are bound to be questions of future regulatory debate.

Transferable securities and other financial instruments, as well as bearer securities, have to be held in custody with the depositary. There is then a series of obligations on the depositary as to what it has to do in acting as custodian. These are different depending on the nature of the instrument but include:

- ensuring the custody investments are properly registered;

- reconciling custody accounts with instruments held;
- reconciling with subcustodians on a regular basis;
- always having an up-to-date inventory of all assets held by the AIF;
- exercising “due care...to ensure a high level of investor protection”;
- assessing all custody risks throughout the custody chain and informing the AIFM of any material risks identified;
- introducing organisational requirements to minimise the risk of loss or diminution in value of the assets, or rights in connection with them, as a result of fraud, poor administration, inadequate registering or negligence;
- verifying the fund’s ownership rights over assets of the fund. To do this, the depositary must obtain “all relevant information it needs”, which must be “sufficient and reliable” for it to be satisfied as to the fund’s ownership rights. The depositary also has to put in place procedures to ensure that assets registered with it cannot be assigned, transferred, exchanged or delivered without the depositary having been informed of such transactions, or at least be informed every time the sale of an asset is agreed;
- ensuring that the AIFM has and implements appropriate procedures to verify that assets are registered correctly; and
- setting up an escalation procedure for notifying anomalies to the AIFM and if necessary to the regulators.

It should be noted that these requirements apply on a look-through basis to all assets held by a fund, ie not just the shares and other participating instruments of the top holdco in a holding structure but the totality of the fund’s assets right down through the ownership chain, save to the extent there is a separate AIF further down the chain with its own depositary regulated under AIFMD, as in the case of a master-feeder structure or fund-of-funds (for example).

The obligation to verify ownership could be onerous for certain types of assets, especially in emerging markets. Practically, this may mean, for alternative assets, the depositary having significant involvement in the

transaction process and/or the manager seeking legal opinions in favour of the depositary on the deals that they close. It could involve depositaries in reviewing agreements, to check for example that no security or other encumbrances have been granted by the seller of an asset to the fund (eg reviewing sale and purchase agreements), and a host of other legal diligence activities, often in multiple jurisdictions, effectively “seconding” what the AIFM will have done. Clearly a combined effort would be most efficient here.

Depositaries’ oversight duties include the following:

- at the time of its appointment, a depositary must assess the risks associated with the AIF’s strategy and the AIFM’s organisation in order to design appropriate oversight procedures for the fund and the assets in which it invests, and then regularly update such procedures;
- depositaries must perform ex-post controls and verifications of all processes and procedures that are under the responsibility of the fund, the AIFM and any appointed third party;
- reconcile subscription (and, if relevant, redemption) proceeds received against subscription documents (and, if relevant, redemption procedures) received, and verify on a regular basis that the reconciliation process is adequate;
- verify on an on-going basis that appropriate and consistent procedures are used in valuing the assets of the fund, and ensuring that the fund’s valuation procedures and policies are effectively implemented and periodically reviewed. This includes checking that external valuers if appointed have all the correct qualifications and can provide all the requisite professional guarantees as required under AIFMD, and includes ensuring that valuations are carried out in accordance with national law, the fund’s documents, and AIFMD valuation requirements;
- depositaries must set up procedures to verify compliance of the fund and the AIFM with applicable laws and regulations as well as the fund’s own constitution. In particular depositaries must monitor compliance with investment restrictions and leverage limits, and escalate where appropriate; and

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- follow-up where consideration on the sale of an asset is not received within the requisite timeframe, or a transaction is not otherwise settled on a timely basis.

Some of these requirements in practice need careful planning and cooperation with the AIFM by the depositary, especially:

- checking proper application of cashflow: this will include, for example, checking that carried interest and distribution waterfalls in fund documents are properly adhered to, which in turn will mean depositaries fully understanding fund documents and potentially being involved in their drafting;
- carefully reviewing and understanding the basis of all valuations: this is likely to require specialist expertise to ensure applicable laws and the fund documents are adhered to;
- monitoring compliance with investment restrictions and leverage limitations: this will involve close liaison with the manager every time an investment is made, examining each proposed investment in the context of the existing portfolio against the restrictions in the fund documents;
- ensuring the fund complies with applicable laws which presumably will include the private equity and asset stripping rules in AIFMD itself, but also all sorts of regulatory, tax and other legal requirements potentially in multiple jurisdictions;
- chasing up purchase price on the sale of assets will require the depositary to work through each sale and purchase agreement the fund enters into for the sale and purchase of assets and identify when purchase price has not been received or paid in time, and to work out when deferred consideration and/or earn-out consideration becomes payable; and
- oversight: verification of the AIFM's processes and procedures is potentially a major task. It requires a detailed knowledge of the AIFM's operations in practice (which the AIFM is required to provide to the depositary). for example, on the acquisition of an asset, all the internal processes of the AIFM as regards due diligence, deal execution, investment approvals, tax structuring, regulatory compliance etc, could fall within this, ie need to be verified as complied with by the depositary. This could require a lot of specialist resources.

At least some of these could lead to depositaries being forced into interfering with managers' investment decisions, something which we doubt anyone will want but a concept with which the parties will nevertheless need to get comfortable.

## **Delegation**

Only the depositary's custody duties can be delegated, and even then only subject to an appropriately documented due diligence procedure in selecting delegates. Generally speaking, the depositary remains strictly liable for the functions it delegates, although there are special provisions when appointing subcustodians, whereby the depositary must carry out certain risk assessments, monitor subcustodians and ensure segregation of assets which in some cases may enable it to avoid liability for subcustodian default.

The other duties of a depositary cannot be delegated, and recent guidance from UK Financial Conduct Authority (FCA) reinforces this. However, "supporting tasks that are linked to the depositary tasks" are not caught by the delegation restrictions, although they may still be covered by FCA's outsourcing rules. There is no guidance as to what these supporting tasks are, and so depositaries will need to consider very closely the extent to which they rely on third parties to assist in the performance of the depositary duties.

## **AIFM responsibility**

It is worth emphasising again that AIFMs are required to ensure that their depositaries comply with these requirements. They are also required to provide depositaries with all the information the depositary needs in order to fulfil its obligations. That said, depositaries also have to be proactive and ask AIFMs for information where needed.

## **Next steps**

Taking all of this together, it is clear that, for those AIFMs and depositaries that have not done so already, the drafting, negotiating and entering into of a depositary agreement is just the start of it. There is a much wider raft of tasks to perform, and a very high degree of cooperation needed.

The depositary requirements in the UK bite on UK AIFMs from the time they become authorised (or 22 July 2014 if earlier). For those expecting to become authorised shortly, the detail of depositary issues needs to be sorted out as soon as possible if not done already. For those still filling in Variation of Permission forms, the depositary arrangements need to be thought through as part of that process. The FCA has issued clear statements to this effect, and warned that any missing information in application packs must be provided a month before authorisation.

And for depositaries, they really need to get to know their AIFMs well in advance of their appointments becoming effective.

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# The Luxembourg perspective on the “Letter Box”

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## What is the policy?

Directive 2011/61/EU on Alternative Investment Fund Managers (the **AIFMD**) has been implemented in Luxembourg by the Luxembourg act dated 15 July 2013 implementing into Luxembourg law the AIFMD (the **AIFM Law**). Commission delegated regulation (EU) 231/2013 of 19 December 2012 supplementing the AIFMD with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (the **AIFMD CDR**) and containing the “letter box” test, is directly applicable in Luxembourg. In addition, the Luxembourg financial regulator, the *Commission de Surveillance du Secteur Financier* (the **CSSF**), issued written interpretation guidelines in the form of frequently asked questions (the **CSSF FAQ**) on 19 July 2013 and updates the FAQ on a regular basis (latest update 17 March 2014).

According to article 82 of the AIFMD CDR, an alternative investment fund manager (**AIFM**) which fails to meet any of the tests described in that article, will be deemed to be a letter-box. In that case, the AIFM ceases to be considered as the AIFM and this may open a re-characterisation risk for other entities in the structure and might lead to other actions by the competent regulators.

## The Letter Box test

The tests are of a factual (eg does the AIFM have the appropriate human resources to effectively supervise the delegated functions) or contractual (eg does the AIFM have the contractual right to give instructions to the delegates) nature or a combination of both. The most controversial test is the extent to which an AIFM would have delegated investment management functions (ie. portfolio and/or risk management) to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself.

Art. 82 sets out a list of qualitative criteria which regulators should take into account instead of considering merely the amount of assets subject to the delegation.

## Scope from a Luxembourg perspective

The letter box test is included in the articles dealing with delegation and the more controversial test referred to above, is only applicable in the case of the delegation of investment management functions. Luxembourg is following this strictly and accordingly, the last – and most cumbersome test – is only applicable if investment management functions have been delegated.

Considering that, certain market participants investigated the possibility of entrusting the risk management function only to the AIFM while retaining the portfolio management function at the level of the AIF’s board (based for instance on advice provided by a separate investment advisor as would normally be the case in a typical PE/RE/infrastructure structure). The CSSF first responded negatively to this type of structure but is understood to be considering it again.

Furthermore, since the delegation provisions are not included in the articles applicable to below-thresholds AIFMs (ie. AIFMs subject to the exemption under art. 3(2) of AIFMD), the letter-box test should not be applicable to those Luxembourg below-threshold AIFMs either.

In the same vein, non-EU AIFMs marketing funds in Luxembourg on the basis of article 42 AIFMD should not be subject to the letter box test.

## General application

To ensure that Luxembourg’s success in the UCITS world can be replicated in the AIFMD world, the CSSF confirmed in its CSSF FAQ two important points in relation to the letter box.

First, it will be favouring a qualitative analysis – that is, a case by case analysis of which functions have been delegated and how important those are – over a strict portfolio management vs. risk management view. “An AIFM may delegate the two functions (ie, portfolio management and/or risk management), in the understanding that an AIFM may not delegate both functions in whole at the same time...Portfolio management and risk management are multi-faceted functions consisting of various core activities and may in that respect be partially delegated.”

Second, it will apply by analogy the guidelines relating to UCITS management companies to delegation structures involving a Luxembourg AIFM. Almost all those requirements are identical to those set-out in AIFMD and include for instance:

- **Monitoring** – The AIFM must be able to monitor its delegates at any time with contractual and practical arrangements for the AIFM’s conducting officers to access the appropriate data.
- **CSSF disclosure** – Any (full or partial) delegation arrangement must be disclosed to the CSSF. This requirement also applies to sub-delegation arrangements.
- **Due diligence** – The AIFM must carry out a due diligence over each proposed delegate including on that delegate’s organisation (rule of conducts, conflict of interest, etc.) and document such due diligence appropriately.
- **Instructions and withdrawal of mandate** – The delegation must not prevent the AIFM from giving instructions to the delegate at any time, or from withdrawing the mandate with immediate effect if this is in the interest of investors.
- **Supervision of the delegate** – The delegate needs to be licensed and supervised in his home jurisdiction.
- **Liability** – The delegation of functions does not affect the AIFM’s liability.

It also specifies that an AIFM should not delegate certain tasks, including:

- the determination of the general investment policy and the risk profile of the AIFs under management;
- the implementation and monitoring of conflicts of interest and best execution policies (depending on the investment strategy);
- deciding on appointments of service providers; and
- monitoring of the delegated functions.

## Conclusion

The wording of the letter box provisions is a result of intense political debate and its adoption has delayed the passing of the AIFMD CDR. The resulting text is complex to apprehend in practice. Fortunately, the CSSF confirmed that the longstanding UCITS experience can be relied upon in Luxembourg. That paves the way for more certainty for all market participants in Luxembourg, including those having recourse to “platforms” (hedge funds) or “rent an AIFM” (private equity/real estate) services.

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# UK FCA Thematic Reviews

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## What is the policy?

The FCA took over from the FSA as the UK's financial services conduct regulator on 1 April 2013. It is committed to more forward-looking and judgement-based supervision than its predecessor with a view to intervening early if it identifies risks to the fair treatment of customers (including risks arising from misconduct in wholesale markets) or market integrity. Thematic Reviews are a key element of this new regulatory approach and involve the FCA doing a "deep dive" on specific areas of concern across firms or in a specific sector of the market. This new supervisory approach involves being more probing on sources of revenue and how a firm's business model delivers against the expectations of customers.

The FCA regards the debate it initiated at its asset management conference in October 2013 as perhaps the best example of its change in regulatory approach, as relevant to the UK asset management sector. In its key note speech, it raised broad questions about asset managers' duties to their clients in the context of the transparency, level and use of dealing commissions. However, this is only one of a number of areas of FCA thematic work relevant to asset managers and forms part of a wider strategy focusing on ensuring that asset managers, acting as agents for their clients, put the customer's best interests at the heart of their business.

The topics which the FCA addresses through Thematic Reviews are likely to be priority areas for enforcement action. They are also likely to be raised by it in EU and international regulatory forums and so have a wider impact, for example, the FCA sees the revised Markets in Financial Instruments Directive (**MiFID II**) as a vehicle for addressing its concerns about soft commissions at an EU level.

Areas of FCA Thematic Review in the asset management sector identified in the FCA Business Plan 2013/14 and Risk Outlook include the following:

- **Outsourcing** – the FCA published the findings of its review in November 2013 and expects firms to review their outsourcing arrangements; in particular, to enhance their contingency plans for the failure of a key service provider and assess the effectiveness of their oversight arrangements. In December 2013, an industry-wide Outsourcing Working Group issued principles to address the regulator's concerns.
- **Conflicts of interest, soft commission and bundled brokerage services** – this review is addressing the FCA's concerns as to the receipt by asset managers of goods and services in return for dealing commission. The FCA expects to put forward proposed reforms in spring 2014 following round table discussions with the industry and targeted visits on selected investment managers and investment banks. At the same time, the FCA is conducting a consultation to clarify the narrow definition of "research" which can be paid for with dealing commission and in particular that "corporate access" is not within scope (see Read More below for our bulletin on this topic).
- **Product design and oversight: fund fee structure** – the FCA's initial evidence suggests that fund fees are high in the UK compared to comparable markets and complex charging structures do not promote consumer choice. It is therefore the undertaking of a project that will highlight the behaviours and practices of asset management firms in relation to charging structures and allow consideration of areas of possible detriment to consumers.
- Awareness and compliance with the rules on **segregation of client assets (CASS)** – supervisory work has shown that a number of asset managers have inadequate records and ineffective segregation of client assets and a key aim for the FCA is to increase firms' compliance. The FCA is undertaking more intrusive visits on firms holding client assets and has stated that it will take tough action and impose fines on firms that still do not have adequate arrangements in place.

- Suitability and record keeping standards in the **wealth management industry** – this continues to be a major focus, with the FCA following up on the actions taken by wealth managers following a previous regulatory review to improve their systems and ensure their customers receive – and can be shown to receive – portfolios that match their risk appetite and meet their investment objectives.
- **AML and Anti-Bribery** – the FCA has expressed concerns as to whether asset managers have taken appropriate steps to mitigate the money-laundering and bribery and corruption risks they face, and has published examples of the good and poor practice found in its thematic review of 22 firms.

### What will it mean for your business?

The FCA's new supervisory approach means that firms need to have procedures to ensure that senior management are aware of the increased regulatory risk around Thematic Review issues. Firms should also have in place procedures to address any concerns that the FCA communicates, and ensure they can react to messages about industry shortcomings at an early stage in the thematic review cycle.

Risk areas addressed in Thematic Reviews are likely to be priority enforcement targets, and the level of any financial penalty may be increased where the FCA believes its regulatory focus and expectations have been made clear.

### Read more

We have prepared a bulletin on the [FCA's consultation on dealing commission rules](#).

List of current FCA thematic reviews  
<http://www.fca.org.uk/news/list?ttypes=Thematic+Reviews>

FCA's thematic review of outsourcing  
<http://www.fca.org.uk/news/thematic-reviews/tr13-10-outsourcing-in-the-asset-management-industry>

Outsourcing Working Group report

<http://www.investmentuk.org/assets/files/press/2013/20131209-owgreport.pdf> ci

FSA's report on conflicts of interest between asset managers and their customers

<http://www.fca.org.uk/static/pubs/other/conflicts-of-interest.pdf>

FCA focus on client assets

<http://www.fca.org.uk/firms/firm-types/asset-management>

FCA Business Plan 2013/14

<http://www.fca.org.uk/static/documents/business-plan/bp-2013-14.pdf>

FCA Risk Outlook 2013/2014

<http://www.fca.org.uk/static/fca/documents/fca-risk-outlook-2013.pdf>

FSA's wealth management review

<http://www.fsa.gov.uk/library/communication/statements/2012/wealth-management-thematic-work>

FCA thematic review on AML and Anti-Bribery

<http://www.fca.org.uk/news/thematic-reviews/tr13-9-anti-money-laundering-and-anti-bribery>

FCA Martin Wheatley speech: Looking ahead to 2014

<http://www.fca.org.uk/news/looking-ahead-to-2014>

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# Tax highlights for asset managers

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In this section we bring you a selection of the most important recent and proposed changes to tax legislation affecting asset managers.

## **Tax impacts of the implementation of the AIFMD**

EU Member States were required to implement the EU Directive 2011/61/EU on alternative investment fund managers by 22 July 2013. The AIFMD does not contain any tax-related provisions. However, changes that AIFs and their AIFMs may implement in response to the AIFMD may potentially raise tax issues.

For instance, an offshore AIF may decide to appoint an AIFM in an EU Member State for easier marketing of the AIF in the EU. A consequence of this may be that the AIF would become a tax resident of, or would otherwise be viewed as having a taxable presence in, the EU Member State where the AIFM is located and therefore be liable for corporate income tax or dividend withholding tax in this EU Member State.

The increased responsibilities imposed by the AIFMD on AIFMs may also have a number of tax implications. AIFMs, in particular those of unregulated AIFs, may not have the capacity to fulfil all the duties imposed by the AIFMD themselves and, therefore, decide to delegate part of such duties to external service providers. In this context, it is crucial to carefully analyse the VAT treatment of the delegated services, in particular to determine if the delegated services can be exempt as investment fund management services or, alternatively, if the VAT may be recovered.

Many EU Member States have or are in the process of introducing new tax measures in the context of the transposition of the AIFMD.

### *France*

In France, the AIFMD was implemented by an ordinance dated 25 July 2013 (the Ordinance). The Ordinance has

updated references made in the French Tax Code to the French Monetary and Financial Code to refer to the new AIF, without any change to the law. Accordingly, management services provided to a French AIF will be VAT-exempt, subject to VAT election, in the same way as those provided to French undertakings for collective investment in transferable securities (**UCITS**). Furthermore, in a private ruling of 26 September 2012 sent to the *association française des investisseurs pour la croissance (AFIC)*, the French tax authorities have confirmed that a non-French AIF would not be viewed as conducting taxable activities in France solely by reason of being managed by a French-based AIFM. Whilst this ruling is not public, it provides comfort that the involvement of a French AIFM should not attract a non-French AIF into France for tax purposes.

### *Germany*

Germany implemented the AIFMD on 22 July 2013 in the Investment Code (*Kapitalanlagegesetzbuch*) and thus abolished the Investment Act (*Investmentgesetz*). As a result, the German Investment Tax Act (*Investmentsteuergesetz*) had to be adjusted. The Act on the Adaption of Investment Fund Taxation in Connection with the AIFM Directive (*Gesetz zur Anpassung des Investmentsteuergesetzes und anderer Gesetze an das AIFM-Umsetzungsgesetz*) passed the lower house of German parliament (*Deutscher Bundestag*) on 28 November 2013 as well as the upper house of German parliament (*Deutscher Bundesrat*) on 29 November 2013. In accordance with the new legislation, the German “transparent” fund taxation regime will apply to units of UCITS and units of AIFs, provided that a stringent list of requirements is fulfilled.

In contrast to the previous situation, a UCITS or AIF

- must generally be subject to supervision by a qualified authority in the state of its statutory seat;

- must generally allow investors to redeem their fund units at least annually;
- must invest at least 90% of its net asset value in a catalogue of permitted assets, as amended, in accordance with the principle of risk diversification;
- must not invest more than 20% of its net asset value in shares of corporations that are not listed on a stock exchange; and
- must not hold a participation of 10% or more of the capital in any corporation; investments in interest of partnerships are generally prohibited, unless the partnerships' business activities are limited to the administration of investment in permitted assets.

Investment funds which have been established pursuant to the new law are subject to a grandfathering provision and can apply for the “transparent” investment taxation regime, even if they do not comply with the new requirements. However, the fund requirements under the former law must also be fulfilled during the transition period, which terminates at the end of the first business year of the fund ending after 22 July 2016. Domestic investment funds which do not meet the requirements under the new law lose their German income tax exemption. Investors in those funds, as well as investors which have invested in foreign investment funds which do not meet the requirements summarised above, will be taxed similar to a holder of shares of a corporation or a partner of a partnership, depending on the respective investment structure.

Only the management of investment funds which fulfil the requirements for the German “transparent” fund taxation will be exempt from German VAT. However, the VAT-exempt outsourcing of investment fund management services will be possible, subject to further requirements to be met.

#### *Luxembourg*

The AIFMD was transposed in Luxembourg by a law dated 12 July 2013. The Luxembourg income tax law now clarifies that a foreign AIF will be exempt from Luxembourg corporate income tax if it is managed by a Luxembourg AIFM. In addition, the Luxembourg VAT law has been amended to ensure that management services provided to an AIF will be VAT-exempt in the

same way and under the same conditions as those provided to Luxembourg-regulated investment funds, pension funds and securitisation companies.

Luxembourg further introduced a new tax regime for carried interest paid to employees of an AIFM who transfer their tax residence to Luxembourg between the start of the fiscal year 2013 and the end of the fiscal year 2018. Under this new regime, carried interest obtained by the employee of an AIFM will, under certain conditions — and for a maximum period of ten years after the fiscal year during which the employee has started his functions related to the carried interest — be subject to income tax at only a quarter of the standard global income tax rate.

Finally, Luxembourg revamped the legal framework of its limited partnership and introduced the special limited partnership, a partnership without legal personality that is transparent for Luxembourg income tax purposes just as the common limited partnership is.

#### *The Netherlands*

The Netherlands has implemented the AIFMD in domestic legislation as of 22 July 2013. The most relevant amendments from a Dutch corporate income tax and dividend withholding tax perspective relate to the rules on tax residency as included in the General Tax Act (*Algemene Wet inzake Rijksbelastingen*). The amendments which have effect from 22 July 2013 are aimed at avoiding uncertainty with respect to the tax residency of foreign AIFs that are managed by a Dutch AIFM. The newly introduced rule states that a non-Dutch AIF is deemed to be a resident of its state of origin for Dutch tax purposes and, therefore, not of the Netherlands provided: (i) the non-Dutch AIF is incorporated or established in accordance with the laws of another EU Member State; and (ii) the object and actual activities of the non-Dutch AIF are solely being engaged in passive investments. The latter condition refers to the Dutch tax-exempt regime that applies to fiscal investment institutions (*fiscale beleggingsinstelling*). Generally, this means that the AIF may only be engaged in investing in passive assets, like tradable securities and real estate.

#### *UK*

The AIFMD was transposed into UK law by regulations having effect from 22 July 2013. The UK government has

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published draft legislation to address the concern that the UK-based activities of an AIFM might cause a non-UK AIF to be treated as UK tax resident. The draft legislation provides that AIFs that are incorporated and tax-resident outside the UK and are either authorised or registered in another Member State (or have a registered office in another Member State) are also not treated as UK tax residents. The legislation is to be enacted in 2014 and to have effect from 5 December 2013.

### **Recent VAT developments impacting investment funds**

One of the most important VAT aspects that concerns investment funds is the question whether services provided to the investment funds may benefit from the VAT exemption of management services provided to special investment funds as referred to in 135(1)(g) of Directive 2006/112 (the **VAT Directive**). Unfortunately, neither the notion of “special investment fund” nor that of “management services” are defined in any way in the VAT Directive. The Court of Justice of the European Union (CJEU) has recently had the opportunity to clarify these notions in two decisions rendered on 7 March 2013.

#### *The notion of “special investment fund”*

In the first decision<sup>1</sup>, the CJEU had to analyse whether a UK pension scheme may qualify as a special investment fund for the purposes of the VAT-exemption of fund management services. The pension scheme in question was set up for the exclusive benefit of former employees of an employer in line with the employer’s obligations under national legislation and collective agreements. The pension benefits of each employee were defined in advance on the basis of the amount of the last salary and the length of service with the employer. Both the employer and the participating employees were required to make contributions to the scheme. The contributions were pooled and invested by the trustee of the pension scheme.

The CJEU observed that each Member State has the powers to define in its legislation the meaning of “special investment fund”, but that such powers must be exercised in compliance with the objectives pursued by the VAT Directive and with the principle of fiscal neutrality. According to the CJEU, the purpose of the exemption of

transactions connected with the management of special investment funds is in particular to facilitate investment in securities by means of investment undertakings by excluding the cost of VAT. Funds which are not undertakings for collective investment within the meaning of the UCITS Directive constitute special investment funds if they carry out the same transactions as UCITS or, at least, display features that are sufficiently comparable for them to be in competition with such undertakings.

In the case at hand, the CJEU concluded that the pension scheme is not a UCITS and that it is not sufficiently comparable to a UCITS. Consequently, it does not qualify as a special investment fund. The CJEU highlighted in particular the fact that the employees’ pension benefits are defined in advance, whereas the return of units in a collective investment undertaking depends on the performance of the investments made by the fund and are therefore subject to change and fluctuation. Furthermore, the employer is not in a situation comparable to an investor in a collective investment undertaking as the employer merely makes contributions to comply with its legal obligations.

#### *The notion of “management services”*

In the second decision<sup>2</sup>, the management company of an investment fund received advisory services from a third party. The service provider advised on the management of the fund and made recommendations for the purchase or sale of assets. In exchange, the service provider was entitled to receive a remuneration expressed as a percentage of the average value of the investment fund. Although the management company was not obliged to follow the recommendations of the external adviser and therefore fully retained its responsibilities, the recommendations were in practice implemented within minutes after checking that they did not infringe any statutory investment restrictions.

In line with its previous case law<sup>3</sup>, the CJEU considered that services qualify as fund management services to the extent that they are specific to, and essential for, the management of special investment funds. The CJEU further clarified that the exemption of management services cannot be denied on the basis that the management of special investment funds is being broken



down into a number of separate services, even if they are provided by a third-party manager. In light thereof, the CJEU concluded that the services at hand constitute exempt fund management services. The outcome of this case is most welcome as otherwise many investment funds would have been required to revisit their management structure.

## Proposed EU financial transaction tax

### *Background to the current proposal*

On 14 February 2013, the European Commission published a revised proposal (the **Proposal**) for a directive which aims at implementing, within 11 participating Member States, a common tax on financial transactions (the **FTT**). The original proposal had been presented by the Commission on 28 September 2011 but, lacking the support of all the Member States, it had been withdrawn. Eleven Member States (Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia) (the **FTT Zone**) renewed their will to implement a common tax on financial transactions and were authorised to do so by the Council pursuant to a little-used procedure within EU treaties; the enhanced cooperation procedure.

The Proposal provides for a broad-based FTT which would apply to financial transactions carried out by “financial institutions” on “financial instruments” (such as shares, bonds or units) and on derivatives (such as repos, reverse repos, securities lending and borrowing agreements). The rate would be defined by each participating Member State but it should not be below 0.1% of the purchase price (or market value if higher) with respect to transactions on financial instruments and 0.01% of the notional amount with respect to transactions on derivatives. The Proposal provides for limited exemptions. For example, there is no market-making exemption as there is for the French domestic financial transaction tax or the UK stamp duty.

### *Impact of the Proposal on investment funds*

The Proposal provides that UCITS, AIFs, pension funds and their respective managers, as well as other types of entities if the average annual value of their financial transactions exceeds 50% of their overall average net annual turnover, qualify as “financial institutions”. It is

notable that there is no exclusion for pension funds, despite the fact that this exclusion has been supported by several Member States, including Germany and the Netherlands.

An investment fund would be liable for the FTT in a number of situations, for instance if:

- (a) the fund is established in the FTT Zone and it purchases or sells securities (whether issued in or outside the FTT Zone) or enters into derivatives (irrespective of the location of the counterparty);
- (b) the fund purchases and sells securities issued in the FTT Zone;
- (c) the fund enters into OTC derivatives with a counterparty based in the FTT Zone; or
- (d) the fund purchases or sells securities through a broker established in the FTT Zone.

In addition, financial institutions would be subject to the FTT if they purchase (subject to the primary market exemption) or sell shares, units or notes issued by a fund established in the FTT Zone. This follows on from the issuance principle.

There is potentially double taxation at the level of the fund and at the level of the investors. Funds established in the FTT Zone which do not invest principally in instruments issued in the FTT Zone or whose investors are not situated in the FTT Zone may want to reconsider their geographic localisation.

### *Criticism of the Proposal*

The Proposal has been subject to criticism from asset managers. For instance, in France, the *association française de la gestion (AFG)* has co-signed an open letter to Pierre Moscovici, France’s Minister of Finance and Economics, denouncing the FTT.

Furthermore, the UK has launched a legal challenge to the FTT before the CJEU based on the extraterritorial element of the Proposal. The lawyers of the EU Council have written in an internal note dated 6 September 2013 that the FTT exceeds national jurisdiction for taxation under the applicable norms of customary international law, “is not compatible” with EU treaties “as it infringes upon the taxing competences of non-participating

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Member States” and is “discriminatory and likely to lead to distortion of competition to the detriment of non-participating Member States”. In response, lawyers for the European Commission have prepared an internal paper which rejects the views of the EU Council’s lawyers.

While European bodies have been considering the legality of the Proposal, the eleven participating Member States have been considering the scope of any FTT. Unanimity is required between the eleven Member States for the enhanced cooperation procedure to be successful. Reports suggest that the 11 Member States are currently not in agreement on the scope of the FTT and it is likely that the Proposal will be revised.

As of today, it is difficult to know when and under which form the FTT will be enacted.

### **FATCA and asset managers<sup>4</sup>**

Sections 1471-1474 of the U.S. Internal Revenue Code of 1986 (**FATCA**) created a new U.S. tax withholding and information reporting regime. Under these rules, a foreign financial institution (an **FFI**) may be compelled to identify and report certain information regarding its U.S. accountholders and investors in order to avoid a 30% U.S. withholding tax. Further, an FFI resident in a jurisdiction that has entered into an intergovernmental agreement with the U.S. (an **IGA**) generally will be required to comply with FATCA’s reporting requirements even where such FFI otherwise would not be subject to the above withholding tax. This reporting can be made either directly to the US Internal Revenue Service (the **IRS**), in the case of an FFI that chooses to enter into an agreement with the IRS (or is required to do so under a “Model 2” IGA), or to the FFI’s local tax authorities, to the extent that the FFI is located in a jurisdiction with a “Model 1” IGA. Although FATCA, on the face of it, deals with taxation, it is the compliance aspects of FATCA that are likely to have the greatest impact on asset managers and their clients.

FATCA’s relevance to the asset management industry is due largely to the expansive definition of “FFI”. In particular, the term FFI includes not just banks, but also asset managers, investment funds, hedge funds and private equity funds. In an acknowledgment that certain

investment vehicles may not have the ability to engage in the necessary diligence and reporting, FATCA permits such funds to delegate their reporting obligations to a manager or administrator (a **Sponsoring Entity**). As such, one of the first steps toward FATCA-compliance for asset managers should include identifying which entities will require the manager to act as a Sponsoring Entity.

Once an asset manager has determined the various entities for which it has reporting responsibility, the next step will be ensuring that the manager has the technical ability to collect and report any required information. This task may include amending the relevant fund documentation, both to require investors to provide any information required by FATCA and to waive any rights that would otherwise prevent the disclosure of such information. The final step to FATCA compliance is putting in place systems to perform the necessary due diligence, both with respect to existing and new accounts. There are multiple standards of information collection that apply to investment entities, depending upon when the relevant accounts were created, the dollar value of such accounts and whether the entity is located in a jurisdiction that has entered into an IGA. Finally, and in addition to collecting and reporting the necessary information to the appropriate tax authorities, it is also necessary for FFIs to register with the IRS through an online “FATCA Portal”, which assigns each FFI a distinct identification number and places the FFI on a master list published by the IRS.

In order to be included on the first list of participating FFIs published by the IRS, an FFI will need to register with the IRS no later than 25 April 2014. FFIs generally must begin performing due diligence on their accounts by 1 July 2014, and reporting with respect to any U.S. accounts is scheduled to begin on 31 March 2015.

### **Potential impact of the BEPS action plan on asset managers**

On 19 July 2013, the OECD released the Action Plan on Base Erosion and Profit Shifting (the **BEPS Action Plan**). The BEPS Action Plan has been commissioned by the G20 Finance Ministers, who have unanimously approved them following on from 20 July 2013. The BEPS Action Plan contains 15 actions to be taken by

governments to develop measures to counter corporate income tax avoidance in cross-border activities by multinational enterprises, each of which is linked to certain outputs that are expected to be completed in 2014 and 2015.

In particular, the BEPS Action Plan seeks to find new measures to prevent double non-taxation and cases of no or low taxation associated with artificial practices (eg artificial avoidance of the permanent establishment status and the use of hybrid loans). To this end, international coherence of corporate income tax systems must be achieved. Transfer pricing and the existence of a permanent establishment (eg in a market where the entrepreneur carries out placement/sale activities) represent critical areas. Further, the OECD highlights that transparency as well as certainty and predictability for businesses are key points to successfully counter Base Erosion and Profit Sharing (**BEPS**). Work streams on the collection and analysis of information regarding taxpayers (including information on their financial assets) will be a crucial point.

Once implemented locally and amongst governments through bilateral and multilateral agreements, some of these actions might indeed impact investment funds and asset managers operating on a multinational basis. For example, the actions aiming to prevent the artificial avoidance of permanent establishments may affect the way asset managers carry on their sale and/or placement activities. Stronger requirements in terms of substance and the management of key risks may impact investment structures as far as the apportionment of risks and profitability is concerned. Finally, the anticipated clampdown on transparency and exchange of information may create a heavy administrative burden for asset managers. It may be expected that information on financial assets held by taxpayers will be attained by tax authorities through reporting instruments by financial institutions and asset managers. Data collection might, therefore, turn into information and disclosure will be provided by these entities, thus creating additional administrative work and the need to pay careful attention to relationships with clients.

The BEPS Action Plan clearly represents an ambitious project in terms of both content and timing. Considering

that the main output of this work will be crystallised in recommendations for domestic law provisions and the amendment of bilateral tax treaties, the effectiveness of these measures and timing of their implementation will largely hinge upon the actions of each country and the local policymakers.

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- <sup>1</sup> CJEU 7 March 2013, C-424/11, Wheels Common Investment Fund Trustees Ltd
  - <sup>2</sup> CJEU 7 March 2013, C-275/11, GfBk, Gesellschaft für Börsenkommunikation mbH
  - <sup>3</sup> CJEU 4 May 2006, C-169/04, Abbey National
  - <sup>4</sup> Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that the US federal tax discussion contained herein (1) was not intended or written to be used, and cannot be used, for the purpose of avoiding US federal tax-related penalties under the US Internal Revenue Code and (2) was not written to support the promotion or marketing of any transaction. Taxpayers should seek the advice of their own independent tax advisers based on their own particular circumstances.

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