CLIFFORD CHANCE
PRIVATE FUNDS UPDATE: SUMMER 2018

Welcome to the summer edition of our private funds update. This briefing contains a selection of short "need-to-knows" covering technical developments relevant to private fund managers operating in Europe. If you would like to discuss any of the topics covered in more detail, please get in touch.

GDPR UPDATE FOR PRIVATE FUND MANAGERS

It is rare that an EU regulation becomes a household name and manages to overshadow most other news, but this feat was very much achieved by the EU's General Data Protection Regulation (GDPR) which came into force on May 25th. The aim of the GDPR is to move data protection compliance from a "papering exercise" to something that is systematically integrated throughout each business that collects and stores personal information. While businesses can naturally continue to collect personal information, they should only do so for legitimate purposes (and only for so long as those purposes require) and should be transparent regarding such collection and use.

For a fund manager to be GDPR compliant, data flows within the business must be assessed and appropriate procedures and controls must be implemented. A consistent consensus position regarding the application of GDPR to private fund structures has emerged, such that generally GPs and managers will generally be data controllers, and fund administrators will be data processors. Depending on the remit of a fund's investment advisor, it may also be a data controller.

In terms of the GDPR's geographical remit, the regime will apply to:

- a fund vehicle/manager/advisory entity domiciled in the EU, regardless of whether any of its investors are in the EU; and/or
- a fund with investors located in the EU, regardless of where the management/advisory and fund vehicles are located.

As such, the GDPR is not simply an issue for EU fund managers to contend with. Even post-Brexit, UK fund managers who market to EU investors will need to comply with the GDPR itself.

There is still some lack of clarity around certain aspects of GDPR. For example, there is continuing uncertainty as to whether a fund manager would be liable for breaches of the GDPR by its portfolio companies. Our general view is that, for so long as the manager is not involved in:

Key issues

- All fund managers should by now have analysed their use of data and data flows within their fund structures.
- GDPR requires a change in approach to the use and retention data and the obligation to explain clearly to individuals how, and on what basis, their data is used, shared and stored.
- Generally, fund GPs and managers will be data controllers, and administrators will be data processors.
- GDPR impacts any manager with investors located in the EU and/or fund vehicles in the EU.

(i) day to day management of the portfolio company's policies relating to data privacy; and/or

(ii) the implementation and ongoing management of the company's data privacy compliance systems,

the manager should not be directly liable. However, this has not yet been tested and there is some inconsistency of views in the market. As the regime beds in, there are likely be developments in GDPR compliance practice that managers need to address in due course.

UK GOVERNMENT ISSUES NEW CONSULTATION ON REFORM OF UK LIMITED PARTNERSHIP LAW

The UK Government has been consulting on the reform of UK limited partnership law for many years. Most recently, the process gave rise to the implementation of the UK's "private fund limited partnership" regime. However, in early 2017 the Government issued a "Call for Evidence" regarding the perceived use of Scottish Limited Partnerships for criminal activity. This has now progressed to a full "Reform of UK Limited Partnership Law" consultation, issued in April 2018 and closing in July 2018.

The consultation paper focuses on:

- Why there has been a significant rise in the number of Scottish limited partnerships registered.
- Whether the limited partnership regime should be reformed to bring it closer to the legal framework applicable to limited companies.
- Whether parties seeking to register a limited partnership should be registered with an AML supervisory body.
- Whether, like limited companies, UK limited partnerships should be required to maintain a registered office in the UK.
- Whether to extend regular ownership reporting to all UK limited partnerships. This could mean extending the PSC regime to apply to English limited partnerships as well as Scottish limited partnerships.
- Proposals to give the companies' registrar the ability to strike limited partnerships from the register in certain circumstances.

The proposals do not come at a helpful time for the UK industry, and many private fund managers (UK and non-EU) have already started using vehicles domiciled in other jurisdictions in anticipation of Brexit. This is unfortunate as

Key issues

- The UK Government continues to focus on the transparency of UK limited partnerships due to concerns regarding the potential use of UK limited partnerships for non-legitimate activities.
- The consultation paper focuses on an extensive range of proposals, including requirements to maintain a registered office in the UK and registration formalities.

the UK has recently implemented the PFLP regime, which brought the UK in line with several other popular fund domiciles. We, and other interested parties, will be responding to the proposals in detail to seek to ensure that the UK limited partnership regime for private funds remains as competitive as possible.

EU LEGISLATIVE MEASURES FOR NON-PERFORMING LOANS - IMPACT ON NON-BANK LENDERS AND FACILITY AGENTS

Credit fund managers should pay close attention to the EU Commission's new proposed Directive relating to non-performing loans[1], which could affect the way that they acquire and manage debt.

The draft legislation is designed to harmonise lending markets across the EU. It seeks to help non-bank lenders by removing local licensing requirements and create a standardised framework for the acquisition of loans on the secondary market. However, the new rules are unexpectedly broad and, importantly, will impact the transfer of performing as well as non-performing assets.

There are three key features that may be problematic for alternative lenders, and in particular for debt funds:

- The legislation would impose mandatory disclosure and liability upon any seller of an EU loan to a non-bank lender (rather than the customary principle of *caveat emptor*). Perversely, this may dis-incentivise banks to transfer to alternative lenders.
- Regulatory notifications would be required in connection with any transfer of a loan to a non-bank lender, and prior to any non-bank lender enforcing a loan. Non-EU lenders will also be required to appoint an "EU representative".
- The EU proposes a new licensing regime for "loan servicers", which would cover any entity with a loan monitoring or loan management role.

Further information will be available when the Commission reports on its consultation process in relation to the draft Directive, which is expected later this year.

Key issues

- The EU Commission's new proposed Directive relating to non-performing loans could affect the way credit fund managers acquire and manage debt.
- The draft legislation is unexpectedly broad and would impose certain disclosure requirements, regulatory notifications and licensing requirements on alternative lenders/loan servicers.

1 Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral and Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures

PRIIPS UPDATE

The PRIIPs[2] regulation obliges manufacturers/distributors of investment funds (and other financial products) to produce a pre-contractual Key Information Document (KID) where the fund is marketed to "retail investors". For these purposes, the definition of "retail investors" is unexpectedly broad. Key takeaways are:

- An investment fund will almost always be caught by the definition of "PRIIP", as "an investment where, regardless of the legal form, the amount repayable to the retail investor is subject to fluctuations, because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor".
- PRIIPs will likely also capture certain executive co-investment vehicles. In some cases, it could also apply to carried interest schemes, although in our view this is unlikely, and we anticipate an eventual industry consensus to that effect.
- Where a PRIIP is "made available" to a "retail investor" in the EU, a KID must be provided to the investor prior to their admission to the fund. The PRIIPs regulation uses the MiFID2 definition of "retail investor". Under MiFID2, any person or entity that is not a professional investor will be a retail investor. This can capture a wide range of investors.
- High net worth individuals, small corporates, public sector bodies, local public authorities and municipalities might be classed as "retail" investors for PRIIPs purposes. It is also necessary to consider whether a professional investor could on-distribute to retail investors.
- Where retail investors can request re-categorisation as professional clients ("opt-up"), a KID will not be required. However, to opt-up, the investor must satisfy the MiFID2 qualitative and quantitative tests, which is difficult.
- A KID is a short factsheet outlining features, risks and rewards of the investment product. Creating a KID is highly technical and includes requirements to calculate a summary risk indicator for the product and certain disclosures around costs. The content of a KID is strictly regulated and must be kept up-to-date throughout the fund's life.
- Penalties for non-compliance are harsh. The fine can be up to €5,000,000 (or equivalent) or up to 3% of total annual turnover OR up to twice the amount of "profits gained or losses avoided because of the infringement".
- A fund's term sheet, marketing documents and subscription agreement should include appropriate legends and selling restrictions to ensure that interests in a fund that constitutes a PRIIP are not made available to retail EU investors without a KID.

Key issues

- Legislation requires a complex Key Information Document (KID) when marketing to "retail investors".
- Definition of "retail investors" is broad, and will often catch participants in executive co-invest arrangements.
- No exemptions available for internal co-investment schemes.

2 The EU Regulation on key information documents for Packaged Retail and Insurance-based Investment Products

CROSS-BORDER DISTRIBUTION OF INVESTMENT FUNDS

In response to concerns about regulatory and administrative barriers to the cross-border distribution of investment funds, the EU Commission has issued legislative proposals to amend the UCITS and AIFM Directives, with the intention of making it cheaper and simpler to market funds cross-border.

The Directive proposes the following changes that, if implemented, could have a significant impact on the way EU and non-EU AIFs are marketed in the EU:

- The incorporation into the AIFMD of a formal definition of "pre-marketing", to allow authorised EU AIFMs to sound out professional investor interest without triggering AIFMD notification requirements. This has the following potential unintended consequences:
  - Impacts reverse enquiry analysis as, if a professional investor later subscribes to the AIF, it could be considered to have been the result of marketing.
  - The proposed definition of "pre-marketing" precludes the use of "offering documents, subscription forms or similar documents whether in a draft or a final form". This is more restrictive than the current position in certain member states.
- Lack of clarity regarding the requirement to have "local facilities" where AIFs are being sold to retail investors, along the lines of the current UCITS requirements.

It is unlikely that the new rules will apply before 19 March 2019, the date the UK leaves the European Union, and it is possible that they will not be in force before the expiry of the transitional period. Therefore, the impact they may have on UK AIFMs will depend on the agreement reached between the UK and the EU on the post-Brexit cross-border distribution of funds, and whether the rules form part of that regime or the rules that apply to third country managers seeking to market into the EU.

Key issues

- The EU has issued legislative proposals to amend the UCITS and AIFM Directives to make it cheaper and simpler to market funds cross-border.
- These proposals include incorporating a definition of "pre-marketing", allowing authorised EU AIFMs to sound out investor interest without triggering notification requirements.
- Significant changes for marketing private funds if implemented, as the "pre-marketing" regime would be more restrictive than at present.

EXTENSION OF THE SENIOR MANAGERS REGIME

From 2019 new, extended, Senior Management and Certification Rules are likely to apply to many fund managers. The Senior Managers and Certification Regime (SMCR) already applies to many banks and insurers in the UK and the Government now intends to extend this regime to all sectors of the financial services industry, including FSMA authorised firms, in 2019.

Key features of the extended SMCR include: regulatory pre-approval for specified "Senior Managers", statements of responsibility (a form of regulatory job profile) for Senior Managers, enhanced individual accountability and the requirement to obtain regulatory references.

The extended SMCR is likely to require substantial changes to training, employment documents and compliance policies and procedures and senior individuals will need to understand the possible impact on them personally.

The Treasury sets the timetable for implementation of the regime. The regulators are expected to publish the final rules in the summer of 2018, with the rules applying to asset managers coming into force in mid-late 2019.

Key issues

- The Senior Management and Certification Regime currently applicable to banks and insurers is being extended and will apply to most fund managers.
- Significant change from the FCA's "approved person" regime and will require changes to employment documents, policies and procedures, recruitment process and training.

THE EU'S SUSTAINABLE FINANCE LEGISLATIVE PROPOSALS

The EU Commission has published a series of legislative proposals that aim to embed sustainable finance into the heart of the investment process and harness "the vast power of capital markets in the fight against climate change and promoting sustainability". These changes have important implications for private fund managers.

The proposals address three main areas:

- establishing an EU sustainability taxonomy;
- formalising investors duties and disclosure obligations in relation to environmental, social and governance (ESG) factors; and
- the creation of low carbon and positive carbon impact benchmarks.

In common with much of the current work in the green finance sphere there is a focus on increased transparency and disclosure to the market.

- The rules on disclosure of ESG risks will be an additional set of disclosures on top of existing AIFMD requirements.
- For products that do not target sustainable investments, managers will need to consider whether in practice this translates into a simple form of additional disclosure (essentially a "tick box" exercise, if a product does not have a sustainability focus) or whether investor expectations will be shifted in terms of a manager needing to consider sustainability more generally in its investment process and strategy.
- Products with a sustainability focus will have additional disclosure requirements on the methodologies used to measure the impact of the investment and the sustainability-related impact of the product.
- Managers can expect investors to be even more focused on sustainability considerations during the negotiation process as institutional investors seek to ensure they are able to obtain the appropriate reporting to meet their own disclosure and compliance requirements.

These proposals will now be discussed by the Parliament and the Council. The Commission is in the process of establishing a technical expert group on sustainable finance which will develop proposals for the Commission on the technical screening criteria. Once agreed, the technical screening criteria will be adopted in a delegated act for each environmental activity over a staggered timetable running from December 2019 - July 2022, with the intention that there is a six-month period between publication of the criteria and its implementation via the Regulation.

Key issues

- The EU Commission has published a series of legislative proposals, with a focus on increased transparency and disclosure to the market.
- The proposals address an EU sustainability taxonomy, ESG factors and carbon impact benchmarks.
- The proposals will be discussed by the Parliament and Council and once agreed will be adopted over a staggered timetable running from December 2019 – July 2022.

CLIFFORD CHANCE

NEW EU MANDATORY DISCLOSURE TAX REPORTING REGIME

The EU Directive on Administrative Cooperation has been amended to require taxpayers and intermediaries to report details of "reportable cross-border arrangements" to their home tax authority. This information will then be automatically exchanged by that tax authority with tax authorities in all other Member States.

Member States are required to transpose the rules into national law by the end of 2019 and to apply those rules from 1 July 2020.

However, the rules (once introduced) will require taxpayers and/or intermediaries to report the details of all relevant arrangements entered into after the amended Directive comes into force – which will be 25 June 2018. Accordingly, taxpayers and intermediaries will need to put in place systems to enable transactions to be captured for reporting from as early as July 2018.

The national implementing rules or administrative guidance may narrow the scope of the requirements – but this will not be known for some time.

What arrangements must be reported?

- The new rules will apply to "reportable cross-border arrangements". An arrangement will be "cross-border" if it concerns a Member State and either another Member State or a third country.
- An arrangement will be reportable if it contains one or more "Hallmarks". The relevant Hallmarks are set out in five broad categories. Some of the Hallmarks will only apply if one of the main benefits that a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage.
- However, importantly, not all the hallmarks include this requirement and hence are of potentially much wider application. One example of this is Hallmark "C(1)(a)" which applies where an arrangement involves a tax deductible cross-border payment made between two or more associated enterprises and the recipient is not resident for tax purposes in any tax jurisdiction.
- This Hallmark may therefore be relevant to many fund structures. Other Hallmarks may also be relevant to fund and investee companies/investment holding company structures.

Who must make the disclosure?

The starting point is that any relevant intermediary based in an EU Member State (such as a professional advisor or service provider) must make the disclosure.

The reporting obligation on intermediaries is however subject to legal professional privilege – and where privilege applies, the intermediary has no reporting obligation. Where that is the case, the intermediary must notify any other relevant intermediary of the disclosure obligation. If no intermediary is required to make the disclosure, the reporting obligation will be on the relevant taxpayer(s). Fund managers will need to give thought to who would be within the scope of this obligation under existing fund structures.

Information to be disclosed

Individual Member States will set the precise content required in reports by taxpayers and intermediaries, but the reports will have to include:

Key issues

- With effect from 25 June 2018, new EU requirements came into effect that will require EU taxpayers and intermediaries to report details of certain cross-border arrangements to their tax authority.
- Member states must implement the rules by the end of 2019, but the reporting requirements will apply to arrangements entered into from 25 June 2018.
- Reportable transactions will be those bearing certain "hallmarks". These are likely to be relevant to many fund structures and fund investments.
- Fund managers should be monitoring transactions within their funds and investment holding structures with immediate effect to determine whether these transactions could be reportable under the regime.

- The identification of intermediaries and relevant taxpayers and, where appropriate, the persons who are associated enterprises to the relevant taxpayer.
- Details of the applicable Hallmarks.
- A summary of the content of the reportable cross-border arrangement, including a reference to the name by which they are commonly known, if any, and a description in abstract terms of the relevant business activities or arrangements.
- The value of the reportable cross-border arrangement.
- The identification of the Member State of the relevant taxpayer(s) and any other Member States which are likely to be concerned by the reportable cross-border arrangement.

Fund managers should start preparing for the introduction of these rules now. Initial next steps should include drawing up a list of transactions within existing fund and investment holding structures that are potentially within the scope of the rules and considering the type of information that would potentially need to be disclosed with respect to those transactions.

US REGULATORY UPDATE

Use of Prior Performance

Investment advisers to US clients and investors are limited in the ways in which they may use their prior performance - known as their "track record" - for fundraising purposes. Many of the rules of the road for the use of prior performance have developed through guidance from the SEC, its staff, and market practice, and are fundamentally linked to an adviser's fiduciary duties to its clients. For obvious reasons, new fund managers are quick to use their investment portfolios from prior firms to market themselves, but they should be careful in doing so. Recent statements from the Commission staff, including a "risk alert" from 2017[3] and its no-action letter from May 2018[4], suggest that advisers' use of track record remains an area of scrutiny - even if, in practice, the differences in presentation appear to be minimal.

While the spectre of US law may vary based on a manager's regulated status in the US, any manager considering raising capital from the US should carefully consider the contents of its marketing materials and use of prior performance. Even established managers looking to expand to different asset classes or products - including by on-boarding new investment teams - would be well served to revisit this issue.

Key issues

- New fund managers are quick to use their investment portfolios from prior firms to market themselves.
- There is evidence to suggest the use of the adviser's track record remains an area of US regulatory scrutiny.
- Any manager (established or not) considering raising capital from the US should carefully consider the use of prior performance.

3 https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf.
4 https://www.sec.gov/divisions/investment/noaction/2018/southstatebank050818.htm.

Volcker Rule

On May 30, 2018, US banking authorities proposed amendments to the "Volcker Rule". Subject to limited exceptions, the Volcker Rule prohibited banks and other financial institutions from "proprietary trading" and investing in "covered funds". The latter was particularly consequential for private fund managers whose investor rosters included US and non-US financial institutions as those institutions sought to achieve compliance with the new rule.

The rule has proven in the intervening five years to be highly complex and compliance with it costly. The recent proposal looks to simplify the rule and to tailor its application on an institution-by-institution basis. The proposal will obviously reopen compliance discussions - and by proxy, interest in private fund investing - but those discussions will remain speculative as "Volcker Rule 2.0" takes shape. The proposal does, however, contain more than 340 questions for public comment, including the treatment of "covered funds". So, while the contours of "Volcker Rule 2.0" are not immediately clear, the market-wide debate that unfolds will be a helpful indicator of what to expect.

Key issues

- The US banking authorities have proposed amendments to the "Volcker Rule".
- The proposal looks to simplify the rule and tailor its application on an institution-by-institution basis.

CONTACTS

Nigel Hatfield
Partner, Private Funds
T +44 20 7006 1834
E nigel.hatfield
@cliffordchance.com

Gerard Saviola
Partner, Private Funds
T +44 20 7006 4958
E gerard.saviola
@cliffordchance.com

Alexandra Davidson
Partner, Private Funds
T +44 20 7006 2581
E alexandra.davidson
@cliffordchance.com

Fionnuala Oomen
Head of Strategy and Delivery, Funds
T +44 20 7006 8392
E fionnuala.oomen
@cliffordchance.com

Anthony Stewart
Partner, Tax
T +44 20 7006 8183
E anthony.stewart
@cliffordchance.com

Richard Kalaher
Director, Tax
T +44 20 7006 1507
E richard.kalaher
@cliffordchance.com

Owen Lysak
Partner, Regulatory
T +44 20 7006 2904
E owen.lysak
@cliffordchance.com

Jeff Berman
Partner, US Regulatory
T +1 212 878 3460
E jeffrey.berman
@cliffordchance.com

Ashwini Habbu
Counsel, US Regulatory
T +1 212 878 3267
E ashwini.habbu
@cliffordchance.com