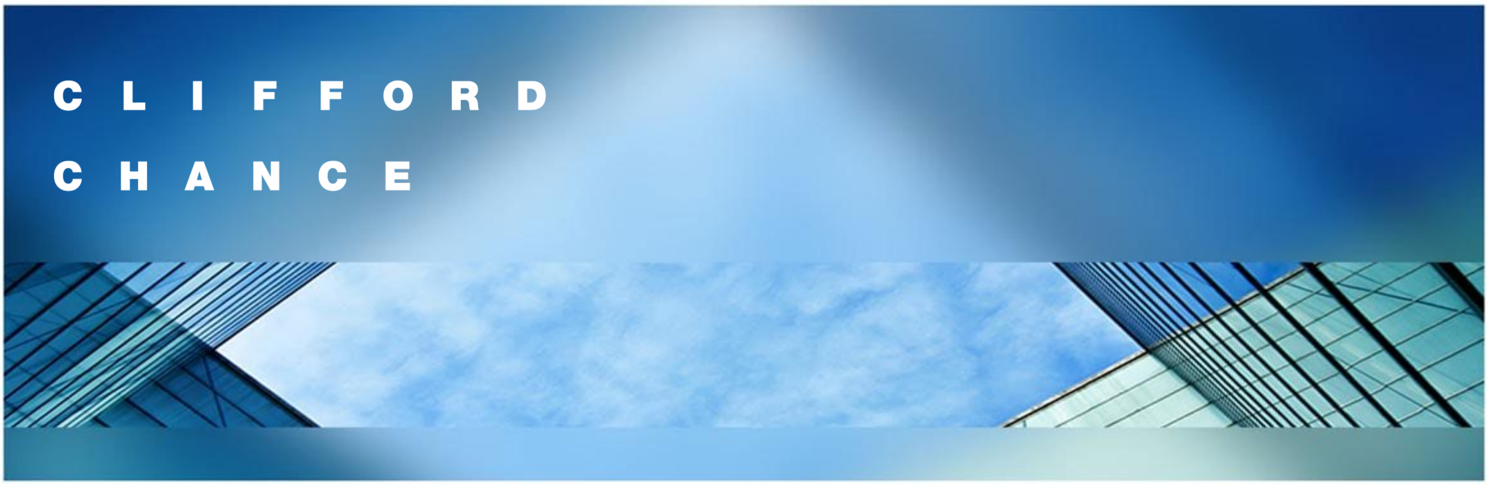


# CLIFFORD CHANCE PRIVATE FUNDS UPDATE: JULY 2020

Welcome to the July 2020 edition of our private funds update. This briefing is intended to give you a short update on key legal, tax and regulatory developments relevant to private fund managers, drawing on expertise from across our Global Funds & Investment Management practice. If you would like to know more about a particular development, please get in touch with any of the contacts listed at the end of this update.

In this edition, we focus on some recent US enforcement actions, sustainable finance, the impact of the pandemic on secondaries transactions, foreign direct investment rules, and liquidity and regulatory forbearance, as well as an update on IBOR transition. In addition, we take a look at some new and proposed fund regimes for Singapore, Hong Kong and the UK, and analyse the latest changes to Luxembourg's AML regime.

## Recent United States Securities and Exchange Commission Private Fund Adviser Enforcement Actions

Several recent SEC enforcement actions against private fund advisers suggest that private fund enforcement remains a major area of focus for the United States Securities and Exchange Commission ("**SEC**"). These actions demonstrate the SEC's particular focus on three areas: (i) the potential misuse of material non-public information; (ii) adequate disclosures of fees and expenses; and (iii) inaccurate marketing disclosures, particular with regard to valuation.

### Potential misuse of material non-public information

On May 26, 2020, the SEC settled an enforcement action against a private fund manager, which alleged that the manager failed to properly implement and enforce policies and procedures to prevent the misuse of potentially material non-public information that one of its employees obtained in their role as a board member of a publicly traded portfolio company.

The manager maintained written policies and procedures relating to the treatment of material non-public information, including measures for when it had an employee-representative sitting on the board of a publicly listed company in its portfolio and there was no allegation that the manager's employees made use of the material non-public information, but nevertheless the SEC found that the manager's policies were deficient in several ways:

- *First*, the SEC alleged that the manager failed to fully address the special circumstances presented by an employee's dual role as a director on a portfolio company's board and an employee of the private fund manager, particularly where the employee had continued involvement in trading decisions regarding the portfolio company's stock.
- *Second*, the SEC alleged that the manager failed to routinely establish information walls with respect to publicly listed portfolio companies where there was an employee-representative on the board.
- *Third*, the SEC alleged that the manager failed to include specific requirements in its policies and procedures for compliance staff with respect to (i) the identification of relevant parties who may have material non-public information; and (ii) the manner and degree to which the compliance staff should discuss issues concerning material non-public information with those parties.
- *Finally*, the manager failed to enforce policies and procedures in a manner that would have resulted in compliance staff sufficiently documenting whether they had made proper inquires with the applicable employee and deal team members, prior to approving potential trades, as to their potential receipt of material non-public information from the portfolio company.

As part of the settlement, the manager agreed to pay a $1 million civil penalty.

## Accurate disclosure of fees and expenses

On April 22, 2020 the SEC settled an enforcement action against Monomoy Capital Management L.P. related to allegedly inaccurate and misleading disclosures of monitoring fees and expenses. According to the SEC, Monomoy used in-house employees in its "Operations Group" to provide services to portfolio companies, and pitched investors on the benefits of this Operations Group in its private placement memorandum and related due diligence materials, but failed to adequately disclose that the Operations Group charged portfolio companies for its services. According to the SEC, this failure meant that Monomoy did not provide full and fair disclosure regarding the Operations Group and did not adequately disclose the attendant conflicts of interest with this arrangement.

The Monomoy settlement was notable, however, for what Monomoy did disclose and the SEC's interpretation of those disclosures:

- Monomoy disclosed that the relevant fund would pay costs associated with "*monitoring fees, consulting fees, directors fees and other similar fees*", which would be partially offset against management fees unless they were for services provided to portfolio companies in the "*ordinary course of business.*" Nonetheless, the SEC concluded that this disclosure was inadequate because Monomoy did not specifically identify reimbursement of costs or conflicts related to the Operations Group.

- Monomoy's March 2014 Form ADV also stated that "*under specific circumstances, certain Monomoy operating professionals may provide services to portfolio companies that typically would otherwise be performed by third parties*", and that "*Monomoy may be reimbursed*" for costs related to such services. The SEC alleged that this was inadequate because, by March 2014, Monomoy "*routinely provide[d] such services*" and "*did, in fact, receive reimbursements*" for such services. Therefore, the disclosure of possible services "*under specific circumstances*" for which Monomoy "*may be reimbursed*" was not a full and fair disclosure.

As part of its settlement, Monomoy agreed to disgorge over $1.5 million and pay a civil monetary penalty of $200,000.

## Misleading and inaccurate disclosures in marketing materials

Two recent enforcement actions related to valuation and marketing disclosures demonstrates the SEC's continued focus on ensuring that advisers provide accurate asset valuations and clear disclosures in their marketing materials.

**In re Everest Capital LLC**

On April 30, 2020, the SEC settled an enforcement action against Everest Capital LLC for allegations related to disclosures regarding investment concentration and risk controls in managing a fund that had highly concentrated investments in the Euro to Swiss Franc exchange rate (the "**EUR/CHF Position**"). According to the SEC, Everest misled investors and failed to make accurate disclosures related to (1) the Everest Fund's gross exposure, and (2) the Everest risk management team's capabilities.

- According to the SEC, the Everest Fund's gross notional currency exposure in these investments ranged from approximately 400% to over 900% of the Fund's assets, bringing the Fund's total gross exposure to over 1300%. Everest Fund's marketing presentations, however, disclosed only that the Fund's gross exposure was approximately 155% to 185%. The presentations omitted an explanation that this disclosed gross exposure range excluded the EUR/CHF Position. As a result, the SEC concluded that Everest misled investors regarding the highly concentrated currency position.
- Everest's marketing presentations stated that its risk management team "*monitors all mandated risk limits of each strategy*", "*enforces strict adherence to these limits*", and can "*reduce risk independent of the investment team.*" Everest's internal risk protocols did not, however, include currencies, meaning that the risk management team did not monitor these positions. According to the SEC, Everest thus failed to disclose to investors that the risk management team lacked the ability to independently reduce currency-related risks, such as the EUR/CHF Position.

Based on the alleged conduct, the SEC found Everest violated Section 206(2) and Section 206(4) of the Advisors Act and Rule 206(4)-8 thereunder and subjected Everest to penalties, including disgorgement of $2 million and a civil money penalty of $750,000.

**Old Ironsides Energy, LLC**

On April 17, 2020, the SEC settled an enforcement action against Old Ironsides Energy, LLC, which alleged that Old Ironsides' marketing materials (1) included inaccurate valuations of prior investments and (2) failed to disclose that an investment responsible for much of the Old Ironsides Energy Fund II LP's (the "**OIE Fund**") positive historical track record was one that the fund's marketing materials stated it would not invest in.

According to the SEC, Old Ironsides miscategorized a high performing investment in a private fund managed by a third-party advisor as a direct investment by the OIE Fund in an oil and gas drilling operator (referred to in the OIE Fund's marketing materials and LPA as an early stage direct drilling investment or "DDI"). Old Ironsides represented in its marketing materials, however, that it would not invest in other private funds. By categorizing the third-party fund investment as a DDI, Old Ironsides significantly improved the track record for its DDIs; the other early stage DDIs had a "*much lower*" return on investment. Additionally, at the time Old Ironsides drafted the marketing materials for the OIE Fund, it had in place, but failed to follow, policies and procedures prohibiting: (i) the distribution of any advertisement which included any untrue statement or omission of a material fact or which was otherwise false or misleading; and (ii) the use of performance results in marketing materials that were false or misleading.

As a result, the SEC concluded that Old Ironsides wilfully violated the Advisers Act by distributing an advertisement which contained an untrue statement of material fact and by failing to implement policies and procedures reasonably designed to prevent Advisers Act violations. As part of its settlement, Old Ironsides agreed to pay a civil monetary penalty of $1 million.

## Key Takeaways

- Private fund managers should maintain clear and adequately enforced policies and procedures relating to the possession and dissemination of material non-public information, in order to prevent conduct that could give rise to Advisers Act violations or potentially even insider trading charges.
- Private fund managers should ensure that where the adviser or its personnel or related affiliates receive fees or reimbursements, the related disclosures are unambiguous and precise in their description of the fees being charged and/or reimbursed by a fund or underlying portfolio companies and the conflicts thereto. That an adviser "may" receive fees or compensation is insufficient disclosure of a conflict of interest when the adviser actually receives such fees or compensation. Disclosure around these issues should be robust enough to allow a reasonable investor to sufficiently understand the practice at issue and the related conflicts in order to form a view on whether to consent or reject the practice.
- The SEC remains committed to policing the use of prior performance by fund managers. Fund managers can take the following steps now to help address these risks:
  - Review existing marketing materials and disclosures to ensure that information is not presented in a manner to elicit from an investor, either directly or indirectly, an improper inference relating to prior, current, or projected investment performance.

- Exercise particular caution when using "back-tested" or other forms of hypothetical performance, as well as projected performance.
- Confirm that legacy investments or investment strategies discussed in marketing materials are similar in nature to those used by the fund being marketed.
- Review statements in marketing materials to confirm their accuracy-that they align with the manager's actual investment practices and with the fund's LPA.
- Clearly disclose the manager's and its staff's role with respect to specific investments, investment strategies, and the performance of the investments and strategies.
- Maintain clear and substantive back-up for all performance information presented in marketing materials.
- Review compliance policies to confirm that effective procedures are in place to prevent the disclosure of inaccurate or misleading performance information and to retain necessary records. Those involved in drafting marketing materials should be properly trained to implement such policies and procedures.

## Sustainable Finance: An Update on the Disclosure Regulation

### Background

Even before the pandemic, sustainable finance and the European Commission's corresponding sustainable finance action plan was a hot topic for fund managers. In recent weeks and months, the EU has adopted a number of pieces of legislation under its action plan that are likely to have a big impact. An example of such legislation is the "Disclosure Regulation", which is amended by the recently adopted "Taxonomy Regulation".

The "Disclosure Regulation" (Regulation 2019/2088) sets out certain requirements for financial market participants (which includes fund managers) with respect to disclosing information on how sustainability risks are considered in the decision-making process in relation to investments, as well as information on how factors such as remuneration are consistent with an overall approach to sustainability.

The requirements under the Disclosure Regulation mean that managers will need to consider their commercial and internal business operations and how sustainability is considered and integrated into these processes, in order to make the relevant disclosures. For further guidance on how the requirements under the Disclosure Regulation impact asset managers, please see our May 2019 briefing, "Clarifying Duties – What Asset Managers need to know", available here.

### Current Status

The Disclosure Regulation came into force on 29 December 2019. Provisions dealing with the development of technical standards are already in application, but the majority of the legislation will start to apply from 10 March 2021. The exception to this are the periodic reporting requirements, which apply from 1 January 2022.

The pre-contractual disclosure and periodic reporting provisions in the Disclosure Regulation will be amended by the recently adopted Taxonomy Regulation (which sets out categories of economic activities that are considered environmentally sustainable and is a cornerstone of the European Commission's Sustainable Finance Action Plan). Specifically, the Taxonomy Regulation requires pre-contractual disclosures and periodic reports for financial products which promote environmental characteristics to include a specific statement regarding the "do no significant harm" principle. It also requires financial products which promote environmental characteristics and financial products which invest in an economic activity that contributes to an environmental objective to:

- include detailed information on that environmental objective (e.g., climate change mitigation, climate change adaptation etc); and
- describe how, and to what extent, the investments underlying the financial product invest in activities considered "environmentally sustainable" under the Taxonomy Regulation, setting out the share of investments in "environmentally sustainable" economic activities, including details on the respective proportions of "enabling" and "transitional" activities, as a percentage of all investments selected for the financial product.

Where a financial product does not have sustainable investment as its objective and does not promote environmental characteristics, the Taxonomy Regulation requires financial market participants to state in pre-contractual disclosures and periodic reports that "*the investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities*". For further information, please see our briefing on the Taxonomy Regulation, available here.

### Impact of Brexit

In the UK, it is still not clear how (or whether) the Disclosure Regulation will be implemented. The original bill dealing with "in flight" legislation (which included the Disclosure Regulation) fell away before the end of the 2017-19 parliamentary session, and so far no new equivalent legislation has been laid. However, the FCA's Regulatory Initiatives Grid indicates that the regulator intends to implement "climate-related disclosures" measures in 2021, so we expect that the UK will be implementing some sort of disclosure regime for asset managers. It remains to be seen how closely aligned any such rules will be to the Disclosure Regulation.

### Practical Considerations

Given the requirements of the Disclosure Regulation and the overall industry focus on environmental, social and governance ("**ESG**") issues, managers should be starting to think about what policies they have in place to ensure ESG and sustainability factors are considered in investment decision making, as well as looking at what disclosures, both pre-contractual and ongoing, will need to be made to investors in order to comply.

## Sustainable Finance: Coronavirus and the Rise of the 'S' In ESG

A particular point of interest when examining the impact of COVID-19 on ESG trends is the fact that it seems to have brought about an increased focus on the "S" - social factors. Historically, the "S" has been the least well understood of the three ESG pillars in terms of its scope and also its metrics, but it is now getting a lot more attention, particularly as a result of the pandemic.

## What are "social" factors?

When the term "ESG" was first coined back in 2005, the concept of "S" (or "social impact") was considered to cover the ways in which businesses conducted relationships with people - both inside the organisation and outside of it. From an employment perspective, it covers a company's own employees, and also those of its suppliers. It also covers a company's customers and the communities that its operations affect. Issues such as modern slavery and business human rights fall within its scope. For example, in a business context the concept of social impact could include issues such as whether there are safe working conditions, the right to a family life, adequate standards of living and the right to a healthy environment. More recently, focus has also increased on issues such as diversity, inclusion and the 'gender/race pay gap', all of which also fall within the "S" remit.

## The impact of COVID-19

The pandemic has arguably brought a number of social impact issues to the fore and accelerated the discussion of "S" as a material business concept. For example, there is now even more of a focus on working conditions - a number of latent issues have been exacerbated by the pandemic and may start to receive more focus in future (such as flexible working policies); and companies are taking a number of actions to benefit the wider communities in which they operate.

The UN PRI has issued a Bulletin setting out the ways in which responsible investors should be responding to the pandemic. There is a strong focus on social impact in their recommended immediate investor actions, which include:

- Engaging with companies that are failing in their crisis management;
- Publicly supporting an economy-wide response;
- Being receptive to requests for financial support; and
- Maintaining a long-term focus in investment decision-making.

## What next for the "S"?

The pandemic is likely to change the sustainable investment landscape in a number of ways, including:

- *Increased environmental and human rights due diligence* - investors may use COVID-19 as a platform to delve deeper into "S" factors to better understand a company's resilience both in times of crisis and in the long-term.
- *Increased attention on supply chains* - the UN PRI has said it will focus on human rights and labour practices in global supply chains.
- *Increased integration of "S" factors into strategies and decision-making* - companies are acknowledging the importance of "S" factors to their long-term success (i.e., their ability to improve a company's reputation and productivity).

In recent years there has been a lot of focus on defining the "E", and integrating those factors into investment decision-making. Now, perhaps accelerated as a result of the pandemic, there are renewed efforts to define the "S" and its role in sustainable investment strategies. The EU Taxonomy will require sustainable investments to be carried out with regard to minimum safeguards that include human rights frameworks targeted on ensuring that environmentally sustainable activities meet human rights standards. It will be interesting to follow the Commission's thinking on whether, and how to, expand the scope of the EU Taxonomy Regulation to categorise socially responsible activities as well as environmentally sustainable activities. For further information and to be kept up-to-date on ESG-related news, you can visit the Climate, sustainability, green finance and renewables Thought Leadership page on our website.

## Secondaries options in Times of Market Dislocation

### Introduction

In light of the COVID-19 crisis, GPs are grappling with short and medium-term liquidity challenges, and understandably therefore this has led to a need for additional and alternative sources of capital. The secondaries market, which has been growing over the past decade and is estimated to have US $120 billion of dry powder, is well placed to provide tools to help GPs meet their liquidity needs, to support portfolio investments and enable growth initiatives. Whereas secondaries transactions might very historically have been viewed as a symptom of a "zombie" or underperforming fund, the mood has very much shifted over the previous ten years, such that these transactions are now generally seen as an important tool to provide liquidity, maximise value extraction and meet capital needs.

A key characteristic of the secondaries market is the diversity of the structures and deal types that have been developed over the previous decade, and that can now be deployed during this time of market dislocation. The breadth and diversity of the secondaries market offers GPs the opportunity to tailor the transaction and its outcomes to their requirements. In other words, different secondaries solutions will be suitable in different circumstances, and it will be important to consider the particular drivers and what the transaction will be required to deliver.

### Annex Funds

To take an example, annex funds are newly established fund vehicles, separate and additional to that of the existing fund structure, which invest into existing portfolio companies with near-term capital needs. Annex funds generally have similar structures and investment terms to those of traditional co-investment, but may also be used in combination with GP-led secondaries transactions to maximise optionality and offer early liquidity for existing investors. In this instance, additional capital would be raised for the annex fund from existing fund investors and new secondaries players, with this capital then provided to support portfolio investments of the existing fund. The existing investors would generally be offered the option to remain invested in the existing fund or sell, and to either participate or not participate in the annex fund, so being afforded flexible liquidity at the same time as the GP obtains more capital. As such, this type of transaction is well suited to circumstances where the GP needs further capital, and wants to combine this with flexibility and liquidity for existing investors.

## Continuation Funds

By contrast, a continuation fund may be more appropriate where the GP wishes to extend the hold period for underlying investments while also creating liquidity for existing investors. A continuation fund is a new fund set up to acquire assets from the original fund and to continue to manage them. Investors in the continuation fund will include existing investors who have elected to "roll" or increase their exposure to the underlying asset, as well as new investors to the extent of any remaining capacity. While it is possible to increase capital available to the underlying investment as an aspect of this type of transaction, this is unlikely to be the key aim - continuation funds are generally seen where the GP believes that a longer hold period would be beneficial to overall returns.

## Summary

Annex funds and continuation funds are of course just two examples of the wide variety of secondaries transactions currently available, and even within those two categories there is naturally a significant degree of difference between each transaction given the complexity of the structures on offer. Clifford Chance's secondaries team has experience across these types of structure, and is currently issuing a series of briefings decoding the secondaries markets and the types of transaction that it encompasses. The existing briefings can be found here (general introduction to secondaries) and here (preferred equity), and further briefings are planned shortly on annex funds and continuation funds.

# New Barriers To Foreign Direct Investment

The coronavirus pandemic has accelerated the trend towards increasing political intervention in foreign direct investment ("**FDI**") in a number of countries, in particular on the grounds of national security. Numerous countries have expanded the scope of their FDI regimes recently, in particular:

- Japan has tightened the regulation of the foreign direct investments in Japan and lowered the threshold for pre-transaction approval for acquisitions of shares in Japanese listed companies from 10% to 1%. Regulated asset managers can be exempted from the pre-transaction approval requirement if the portfolio investment conditions are satisfied. An activist investment cannot satisfy the portfolio investment conditions. Private funds (including accredited sovereign wealth funds and public pension funds who have signed a MOU with the relevant Japan authority) can also be exempted but when investing in core sectors (such as arms, aircraft, space, nuclear, medicines or cybersecurity), the conditions to be complied with to rely on the exemption are stricter than those for the asset managers. For further details, see our May 2020 briefing.
- The United States has expanded the jurisdiction of its Committee on Foreign Investment in the US (CFIUS) regime to cover certain non-controlling investments and acquisitions of greenfield real estate transactions, with mandatory filing obligations for certain investments involving critical technologies.
- Various counties have lowered the thresholds for application of their FDI regime in response to the coronavirus pandemic. For example, Australia temporarily withdrew all thresholds, meaning that almost any deal with an Australian component requires clearance under its Foreign Investment

Review Board (FIRB) regime. France, Germany, Italy and Spain have all lowered the level of shareholding that triggers an FDI filing and/or expanded the scope of sectors covered by the regime, while Poland and the Czech Republic are in the process of introducing new FDI screening regimes.

- The EU's Foreign Investment Screening Regulation - which becomes applicable in October 2020 - will significantly increase information sharing between EU governments on national security implications of FDI transactions, which is likely to increase the risk of government intervention for some deals. The Regulation also clarifies the circumstances in which EU governments can intervene in such investments and the factors that they can take into account, and a number of EU governments have expanded their laws to make full use of these factors.
- The UK will shortly introduce the National Security and Investment Bill, which will create powers for the government to intervene in a much wider range of transactions on national security grounds than it can at present. In addition, as a stop-gap measure pending the adoption of the new legislation, the government has also clarified that it has powers to intervene in transactions that might affect the UK's capabilities to combat the pandemic - such as acquisitions of vaccine developers or suppliers of personal protective equipment - and is lowering the thresholds at which it can review mergers involving targets active in advanced materials, artificial intelligence or cryptographic authentication.
- Looking ahead, in a development that could create significant obstacles for some foreign investors, the European Commission recently announced plans for sweeping new powers to block transactions on the basis that the buyer has been subsidised by a non-EU government, with a filing regime that would catch businesses that buy or sell significant amounts from non-EU governments, irrespective of whether they enjoy subsidies.

## Recent Developments in Liquidity

Liquidity is proving to be an increasingly hot topic for fund managers and regulators alike, particularly in light of the COVID-19 pandemic and the collapse of the Woodford funds. In this short update we take a look at the new guidelines for liquidity stress testing and also the impact of COVID-19 on liquidity - both for investors and for fund managers.

### ESMA guidelines on liquidity stress testing for UCITS and AIFs

In February 2018, the European Systemic Risk Board (the "**ERSB**") published a set of recommendations (dated December 2017) to address liquidity and leverage risk in investment funds. One of the ERSB's recommendations requested that the European Securities and Markets Authority ("**ESMA**") develop guidance on liquidity stress testing for UCITS and AIFs.

Following a consultation, ESMA published its final report and guidelines on liquidity stress testing for UCITS and AIFs in September 2019 (the "**Guidelines**"). The Guidelines will apply from 30 September 2020. They apply to managers (which is defined within the Guidelines to include UCITS managers, AIFMs and managers of MMFs) depositaries and national competent authorities, and apply in respect of UCITS and AIFs, including ETFs and leveraged closed-ended AIFs. Amongst other things, the Guidelines state that managers should ensure that liquidity stress testing:

- is documented in a liquidity stress testing policy within the documented risk management policy.
- is carried out at least annually, although quarterly or more frequent liquidity stress testing is recommended. Flexibility is allowed on this issue depending on the fund's nature, scale, complexity and liquidity profile.
- is appropriately adapted to each fund.
- employs hypothetical and historical scenarios and, where appropriate, reverse stress testing.

The Guidelines contain specific provisions relating to funds investing in less liquid assets. Amongst other things, these state that one way in which a manager could consider the liquidity of such a fund is to prioritise undertaking ad hoc liquidity stress testing where a forthcoming event has been identified which could have a negative impact on fund liquidity. Funds of funds, which gain indirect exposure to less liquid assets via their target funds, should also pay due regard to considerations relating to less liquid assets.

Managers within the scope of the Guidelines should review their liquidity stress testing procedures in light of the Guidelines to identify any areas in which potential changes are needed.

## Impact of COVID-19

COVID-19 has raised liquidity issues for private equity managers, both in relation to their investors (and the likelihood of potential defaults) and their portfolio companies.

If managers choose to increase leverage to improve liquidity, whether through existing loan facilities, total return swaps, margin loans or other alternative forms of financing, existing fund documentation will need to be reviewed in terms of borrowing limits and other restrictions, and these documents may need to be updated. In addition, funds will need to review their compliance with any applicable regulatory capital and liquidity rules and regulatory and public reporting and announcement obligations. There may, for example, be regulatory implications on increasing leverage such as for alternative investment funds under the AIFMD.

Portfolio companies may experience liquidity problems, prompting managers to consider accessing the various government support programmes, although this has proved difficult in some jurisdictions due to issues with portfolio companies being "grouped" and thus falling outside the relevant turnover thresholds. In the UK, however, guidance has confirmed that private equity-backed businesses are eligible for the Coronavirus Business Interruption Loan Scheme and Coronavirus Large Business Interruption Loan Scheme (although access issues remain due to the application of the 'undertakings in difficulty' test under the EU Temporary State Aid Framework). Amongst other measures, the UK Government has also implemented a scheme to issue convertible loans of between £125,000 and £5m to UK-incorporated limited companies that have raised at least £250,000 in aggregate from private third party investors in the last five years, can attract the equivalent match funding and for whom at least half or more of their employees are UK-based or half or more of their revenues are from UK sales (the "**Future Fund**"). You can find more details about the UK's Future Fund in our briefing here.

# THE REGULATORY PIPELINE 2020 - REVISED DEADLINES AND FORBEARANCE DUE TO COVID-19

The global outbreak of the coronavirus - COVID-19 - is having a deep impact on businesses across all sectors, including financial services, funds and investment management. In response to COVID-19, UK and EU regulators and policy makers have announced delays to deadlines for compliance with a variety of obligations, including through regulatory forbearance statements and changes to dates which are key milestones in the legislative process.

## Forbearance in periodic reporting

In the funds sector, one of the most significant forbearance statements has been in relation to periodic reporting. On 9 April 2020, ESMA issued a forbearance statement covering reporting by fund managers under AIFMD and the EuVECA and EuSEF Regulations. ESMA expected national competent authorities (NCAs) not to prioritise supervisory actions against market participants during the forbearance period and to apply their supervisory powers in this area in a proportionate manner.

The statement asked NCAs to allow an additional:

- 2 months for annual reports referring to a year-end occurring on or after 31 December 2019 but before 1 April 2020; and
- 1 month for annual reports referring to a year-end occurring on or after 1 April 2020 but before 1 May 2020.

The FCA has confirmed that it will give firms an additional two months for annual reports. This forbearance measure remains under review. The deadlines for reporting transparency information to the FCA under AIFMD Level 2 Commission Delegated Regulation (EU) No 231/2013 are unchanged.

The FCA maintains a webpage summarising its expectations regarding funds in light of COVID-19 more broadly, including on virtual general meetings and electronic signatures amongst other things.

ESMA also maintains a webpage summarising its actions and recommendations in response to COVID-19.

## Legislative timelines

As well as forbearance, COVID-19 has had an impact on EU regulatory timelines, which in some cases have been extended. In the UK, the FCA has issued a Regulatory Initiatives Grid which sets out the planned regulatory workplan over the next 12 months. In response to COVID-19, the FCA has delayed several initiatives to reduce operational burdens on firms e.g. in relation to operational resilience and MiFID2 product governance requirements, although the timing of some key initiatives such as IBOR transition and the Investment Firms Prudential Review remain unchanged. In terms of planning for regulatory change, the delays are likely to result in the finalisation of a number of policy initiatives at the end of 2020, which of course coincides with the end of the Brexit transition period. The eventual implementation dates for these policies will be an important consideration in the operational burden placed on managers.

Further details of the legislative pipeline, including revised deadlines and forbearance statements, can be found on the Regulatory Horizon Scanner on the Financial Markets Toolkit.

## IBOR Transition - Planning for Change

Notwithstanding the impact of COVID-19, the UK regulators have recently confirmed that the target date for the cessation of LIBOR remains the end of December 2021, and that asset managers should be preparing now for the transition away from IBORS to risk-free rates. This has implications for a broad spectrum of asset managers, including those of private funds.

### Where might LIBOR be used?

Typically, IBOR is used in financing or hedging transactions e.g. loan agreements, bonds and derivative transactions. Private equity, for example, is heavily reliant on credit, so it is likely that portfolio debt financing arrangements and associated hedging are heavily-IBOR based. IBOR may also be used in a range of commercial contracts (e.g. in relation to late payment provisions), intra-group arrangements and also for pricing models, discounting assumptions and operational systems. Therefore, if not already undertaken, managers should now conduct a due diligence review to identify where LIBOR is used and what replacement rates may be appropriate, what contracts need to be updated or replaced and what fall-back rates might be relevant.

### What should you be doing?

If not already in place, a transition plan should be prepared as a priority. In the UK, the FCA has written to asset managers (including private equity firms) requiring them to have a transition plan in place dealing with the end of LIBOR by the end of 2021. Firms' transition plan should not assume that regulatory initiatives will solve the problem - the FCA expects the industry to take the lead and not rely on future regulatory relief or on legislative solutions, even though the market has requested this to be considered in relation to "tough legacy contracts". Even if banks or other finance providers undertake the repapering of existing IBOR-based financing arrangements, managers should understand the commercial and practical impacts of the transition away from forward-looking IBOR rates on portfolio investments and models, including for new investments. For example, the replacement rate may not produce an outcome which is precisely equivalent in economic terms as IBOR as, although the market will seek to minimise value-transfer, some divergence is inevitable and so the impact of the transition on financial models should be evaluated.

The stages a LIBOR transition project might typically include are shown in the figure below.

| Stages of an IBOR transition project |
|---|
| 1. Transition planning. This should cover firms' regulatory obligations, stakeholder communications and internal team education. |
| 2. Due diligence exercise on existing IBOR exposures covering both funds and portfolio companies. Map the interconnectedness between different IBOR exposures |
| 3. Coordination, communications and engagement. A coherent approach will allow for efficient communication with directors, portfolio companies and other stakeholders. It will also allow for coordinated engagement with bank groups and hedging counterparties reducing the potential for lengthy and costly renegotiations. |
| 4. Product specific implementation strategies. Loans, bonds and derivatives each present their own implementation challenges and the practical challenges of amending documentation and coordinating consents should be planned for. |
| 5. Refresh credit policy for future investments. Different product markets are switching to IBOR alternatives at different times and potentially in different ways. Your refreshed credit policy should ensure that your inventory of IBOR exposures is not expanding whilst mindful of the liquidity of alternative rates in the relevant markets. |

### What other issues need to be considered?

In addition to formulating a transition plan, managers must consider whether the products and services they offer continue to meet the needs of investors and continue to perform in the manner expected. Governance and planning are critical and it is expected that the board has oversight of the transition process with support from senior management. Firms must consider the various risks that might arise from the transition (for example, conflicts of interest which must be mitigated or managed appropriately). The FCA has published a Q&A on conduct risk during LIBOR transition to assist in this.

Further information on the impact of IBOR transition on asset managers can be found on our Insights for Asset Managers calls and Topic Guide.

## Launch of the Variable Capital Companies (VCC) Framework in Singapore

On 14 January 2020, the Monetary Authority of Singapore ("**MAS**") and Accounting and Corporate Regulatory Authority ("**ACRA**") launched Singapore's new Variable Capital Companies ("**VCC**") framework, thus strengthening the array of fund structuring options that available to fund managers in Singapore.

The VCC is a new corporate structure that can be used for a wide range of investment funds and provides fund managers greater operational flexibility and cost savings. A Working Group, formed under the Singapore Academy of Law and led by Clifford Chance, prepared VCC model constitutions to reduce the time required to incorporate a VCC. Fund managers will be able to constitute investment funds as VCCs as open-ended or closed-end funds and may also incorporate new VCCs or re-domicile their existing investment funds with comparable structures by transferring their registration to Singapore as VCCs.

Key features of the VCC are as follows:

**Management** - a VCC must be managed by a fund management company duly registered or licensed by the MAS under the SFA.

**Limited liability** - the liability of members of a VCC will be limited to the amount, if any, unpaid on the shares held by them respectively.

**Issuance of Shares** - a VCC may issue shares of varying amounts and issue payment of calls at such time as agreed between its shareholders. It can accept members without having its shares fully paid up and can pay dividends in proportion to the amount paid up on each individual share, such that a larger amount may be paid on some shares as compared to others.

**Redemption** - unlike shares in companies incorporated under the Companies Act (Chapter 50) of Singapore (the "**CA**"), shares in VCCs may be freely redeemable subject to the terms of redemption of shares set out in the constitution of the VCC, which enables VCCs to be used as open-ended funds. An umbrella VCC may also have the flexibility to use liquidity management tools, provided that any rights or limits to redemption are clearly set out in the VCC's constitution.

**Umbrella structure** - unlike companies incorporated under the CA, VCCs may be formed as single funds or even umbrella VCCs with multiple sub-funds. An umbrella VCC will be a single legal entity with sub-funds that have segregated assets and liabilities, but each sub-fund will not have its own separate legal personality. The framework provides for certain disclosure requirements for umbrella VCCs, allows for cross sub-fund investment, and for each sub-fund to be wound up as if it were a separate legal person.

**Confidentiality** - a VCC is not required to disclose its register of shareholders, or its constitution to the public. However, it must make its register available to the necessary regulatory and law enforcement authorities on request. In addition, information on share allotments and redemptions will not be required to be lodged with the Registrar. The financial statements of VCCs are not publicly available.

**Taxation** - a number of features make the VCC structure a compelling fund structuring option from a tax perspective:

- existing tax exemptions under sections 13R and 13X of the Income Tax Act (Cap. 134) of Singapore will be extended to VCCs. These incentives will be granted at the umbrella level for umbrella VCCs;
- a VCC will be treated as a company and a single entity for tax purposes, and only one set of income tax returns will be required to be filed with the Singapore tax authority even if the VCC is an umbrella VCC with multiple sub-funds;
- deductions and allowances will be applied at the sub-fund level for determining the sub-fund's chargeable or exempt income;

- the 10% concessionary tax rate under the Financial Sector Incentive - Fund Management scheme will be extended to certain Fund Managers managing incentivised VCCs;
- as a corporation with its own legal personality, a VCC will be able to access Singapore's network of DTTs more easily as compared with other fund structures, potentially making VCCs attractive to investors accessing investments across Asia and beyond; and
- a VCC may make an election under the US "check the box" rules to be treated as a "pass-through" entity for US federal income tax purposes, further enhancing the attractiveness of investing in VCCs for US taxable investors.

The MAS expects the introduction of the VCC framework to encourage more funds to be domiciled in Singapore and enhance Singapore's value as an international fund management centre. Our briefing on the VCC framework can be found here.

## Hong Kong Limited Partnership Funds Regime

On 20 March 2020, Hong Kong gazetted the Limited Partnership Fund Bill, paving the way for the introduction of a new limited partnership fund structure ("**LPF**"). Hong Kong already plays host to a well-established fund management industry, and the introduction of the LPF offers an opportunity for Hong Kong to further develop itself as a global investment fund domiciliation hub.

### Summary of LPF Regime

Consistent with other international limited partnership regimes, an LPF will not have legal personality, must be constituted by a written limited partnership agreement and have at least one general partner and one limited partner. The LPF regime allows for broad contractual freedoms in respect of the fund's operation, giving the partners flexibility to craft the fund's terms to suit their needs.

The general partner will have unlimited liability for all debts and obligations of the LPF and must be either a Hong Kong private company limited by shares, a non-Hong Kong company registered with the Companies Registry in Hong Kong, a limited partnership (whether domestic or foreign), an LPF or an individual who is at least 18 years old. A limited partner of an LPF will not be liable for the debts and obligations of the LPF beyond the amount of the limited partner's agreed contribution, unless the limited partner takes part in the day-to-day management of the LPF (a non-exhaustive "white list" of actions is set out in the draft legislation).

An LPF will be required to appoint either a Hong Kong resident individual (over the age of 18) or a Hong Kong incorporated company or registered non-Hong Kong company to act as the LPF's investment manager, who will need to be licensed by the Securities and Futures Commission if it carries on regulated activities. A general partner meeting these criteria can appoint itself as the investment manager. Moreover, an LPF will be required to appoint a Hong Kong registered auditor and a "responsible person" to carry out certain AML and counter-terrorist financing functions.

From a tax perspective, provided it meets certain criteria, an LPF will be able to benefit from Hong Kong profit tax exemption. Interests in an LPF will not be considered "stock" and will therefore not attract stamp duty on the transfer or withdrawal of an interest in an LPF. Hong Kong has also announced that tax concessions for carried interest are being considered, however, no further details have been provided at this time.

## Retail Funds - A New Regime for Overseas Funds Proposed by the UK

One of the most notable trends in the recent years has been the move towards the "retailisation" of private funds, with managers increasingly targeting high net worth investors or establishing retail funds in order to maximise capital-raising opportunities. Managers in this position might be interested in recent developments in the UK, where the government is proposing a new regime - the Overseas Funds Regime or OFR - to streamline the process by which retail funds are marketed to UK investors. The current process under section 272 of FSMA has long-known drawbacks, so reform was a key priority for the asset management industry, especially as Brexit will mean the loss of the marketing passport, which has been a major route for marketing UCITS in the UK.

Broadly speaking, section 272 of FSMA sets out the process under which overseas funds can become "recognised" in the UK and subsequently marketed to retail investors. The section 272 process has been criticised for some time for being unduly cumbersome but would have become a much bigger problem post-Brexit: many overseas funds currently marketed into the UK are domiciled in EEA member states and are marketed to UK retail investors via the UCITS marketing passport, which will cease to be available at the end of the Brexit transition period in December 2020. The UK temporary permissions regime, designed to avoid a cliff-edge on exit day, permits EEA UCITS to continue be marketed in the same way as under the passport for a limited period, during which time the fund must become recognised under section 272. The result would be that many of the 8,000 or so EEA funds that are currently marketed in the UK under the UCITS passport would be forced into the section 272 bottleneck, hence the UK government's proposals to introduce a new regime to streamline the process.

Section 272 will be not repealed, however, and will remain in place (again in a streamlined form) for those funds that are unable to use the OFR (for example, because the regulatory regime in the country of domicile for that fund is considered by the UK Treasury not to be "equivalent" to that in the UK). Where a positive equivalence decision has been made, however, on the basis that the jurisdiction of fund domicile has as least equivalent investor protection and a supervisory cooperation agreement in place with the UK, retail funds can register with the FCA and have their "recognition" confirmed. Recognised funds can then be marketed to UK retail investors subject to complying with the obligations under the OFR, such as disclosures, for example, and any additional requirements that are deemed necessary to ensure comparability with UK authorised funds.

The OFR is primarily intended to provide an efficient route for marketing overseas funds to retail investors in the UK, although it could be used to market to non-retail as well once the fund has become "recognised". However, there appear to be no plans to amend the UK national private placement rules, which remain available as a route to market to non-retail investors. There have been calls for this to be made explicit, as well as for clarification on some "grey areas" around retail/non-retail classifications, or for an exemption in some circumstances, for example where a fund has been classed as "retail" only because certain employees of a fund have received remuneration in the form of shares or units of the fund, as is required in the remuneration rules of AIFMD and the UCITS Directive.

The OFR is still at the proposal stage. HMT issued a consultation in March this year which ended on 11 May 2020 and the UK government's response will be issued in due course. A Financial Service Bill, which will include the OFR, will be introduced shortly.

## Amendments to the Luxembourg AML/CTF Law Implementing Certain Provisions of AMLD 5

There is no doubt that, given the number of money-laundering scandals hitting the headlines in recent times, there has been a huge focus across the globe on strengthening anti-money laundering procedures. In the European Union, the introduction of the Fifth Anti-Money Laundering Directive (Directive (EU) 2018/843, "**AMLD5**") is one such example of this trend. In this update, we focus on the changes that Luxembourg has introduced in order to implement the provisions of AMLD5.

The Luxembourg law of 12 November 2004 on the fight against money laundering and terrorist financing ("**AML/CTF Law**") has been amended by two new laws of 25 March 2020, which both entered into force on 30 March 2020 and implemented certain provisions of AMLD 5, resulting in an extended scope and more detailed, specified and reinforced provisions of the AML/CTF Law. For the sake of completeness, it is worth mentioning that one of these laws further introduces a centralised electronic data search register concerning IBAN accounts and safe-deposit boxes, whilst the AMLD 5 transparency requirements concerning the register of beneficial owners of Luxembourg entities registered with the Luxembourg Trade and Company Register had already been implemented by the law of 13 January 2019 creating a central register of beneficial owners (for further information on this latter point, please refer to our briefing on the law of 13 January 2019).

The AML/CTF Law is applicable to various professional entities, including Luxembourg investment funds, management companies and alternative investment fund managers ("**Fund Parties**", including any relevant service providers of those parties where relevant). The main amendments introduced to the AML/CTF Law that may impact the private fund industry are briefly described below.

### Risk Assessment Obligation

The AML/CTF Law has been amended, among others, to specify that the risk assessment to be done by Fund Parties in order to identify, assess and understand the risks of money laundering and terrorist financing that they face must take into account:

- all the relevant risk factors before determining their overall risk level and the level and type of appropriate measures to be applied in order to manage and mitigate these risks;
- the information on the risks included in the national and supranational risk assessments or communicated by supervisory authorities and self-regulatory bodies or by the European supervisory authorities.

## Customer Due Diligence (CDD) Obligations

### Standard CDD

The obligation of Fund Parties to identify and verify the identity of their customers, including more particularly the investors of investment funds as applicable, and the beneficial owner(s) of their customers/investors as well as, where applicable, their customers'/investors' proxyholder, has been clarified, namely by specifying:

- the measures to be taken to identify and verify the identity of the customers'/investors' proxyholder;
- the identification methodology for customers/investors which are legal entities and the measures to be taken by the Fund Parties to understand the nature of such customers'/investors' activities, to verify their legal structure, and to collect information on these customers/investors and their directors.

In addition, although the concept of "beneficial owner" still has the same definition in the AML/CTF Law, the criteria and methodology to assess and establish the notion of "control through other means" that a beneficial owner may exercise over a customer/investor which is a corporate entity have been further specified in the AML/CTF Law.

### Enhanced CDD

The status of "politically exposed person" or "PEP", which imposes on Fund Parties the obligation to apply enhanced CDD in addition to the standard ones, has been updated to also include certain physical persons exercising a function mentioned on a list published by the EU Commission. Moreover, the PEP status is no longer considered as expiring one year after the cessation of the relevant prominent public function by the relevant PEP, potentially leaving the holding of this status by a physical person unlimited in time. However, Fund Parties shall consider the risk resulting from this PEP status together with the application of appropriate measures for at least 12 months after the cessation of the public function by the relevant person and until such person does not present any specific risk anymore.

The concepts of complex or unusual transactions and high risk countries (identified as such by the EU Commission, the FAFT or any other supervisory authority or Fund Party as part of their risk assessment) have also been further clarified, as well as the mandatory enhanced CDD measures that have to be applied in such cases by Fund Parties. In particular, Fund Parties are required to increase the degree and nature of monitoring measures of the business relationship in case of complex or unusual transactions in order to determine whether those transactions or activities appear unusual or suspicious. In case of transactions involving a high-risk country, the relevant Luxembourg competent authorities (e.g.. the CSSF as regards regulated investment funds and their managers) will require that the Fund Parties apply the case being one or more additional enhanced CDD measures, including the obligation to limit business relationships or transactions with physical or legal persons form a high-risk country. Other specific counter-measures may also be decided and applied by the relevant Luxembourg competent authorities vis-à-vis high-risk countries, such as the prohibition for Fund Parties to establish branches or representation offices in these countries, provided that the relevant measure is notified to the EU Commission prior to its adoption or application.

**CDD Implementation**

The identification and verification of the identity of the relevant Fund Parties' customers/investors (and of their beneficial owner(s) and proxyholders) is now explicitly allowed also through electronic identification means and trusted services as provided for in Regulation (EU) 910/2014, as well as through any other secure, remote or electronic identification process regulated, recognised, approved or accepted by the relevant national authorities.

Certain other aspects of the implementation of the identification process of the relevant Fund Parties' customers/investors (and of their beneficial owner(s)) have also been further specified, such as the obligation for Fund Parties to collect and store (for the same duration as the other data) a proof of registration of their customers'/investors' beneficial owner(s) in, or an excerpt of, the relevant register of beneficial owners. The amended AML/CTF Law also allows a Fund Party to choose not to pursue its due diligence process over a customer/investor, but to make a suspicious transaction report directly to the Luxemburg Financial Intervention Unit, in case such Fund Party suspects that a transaction relates to money laundering or terrorist financing and reasonably believes that performing that due diligence process will alert the customer/investor.

Finally, the AML/CTF Law has been amended to recall and further clarify the possibility and specific requirements (e.g., in terms of eligibility criteria, proper due diligence and provision of information/documentation, etc.) according to which Fund Parties may rely on third-parties in the performance of certain of their CDD obligations. In this respect, the AML/CTF Law specifically provides that such requirements shall be considered as complied with, subject to certain conditions, for Fund Parties and third-parties which are part the same group.

## Internal Organisation Requirements

The AML/CTF Law has been slightly amended to remind Fund Parties and clarify, among other things, that:

- their internal organisation shall include the establishment of appropriate procedures to ensure that the hiring of their staff members is made according to applicable professional standing and experience criteria, as well as the organisation of appropriate AML/CTF training programs for their employees and for the members of their management body and effective direction;
- their internal control functions shall be adequately resourced to test compliance with the procedures, policies and controls and to enjoy the independence which is necessary to perform their tasks;
- certain specific conditions have to be complied with in relation to AML/CTF group policies and procedures.

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## SMCR Manager

The SMCR Manager is an interactive digital tool to assist clients with the implementation of the Senior Managers and Certification Regime.

The FCA Senior Managers and Certification Regime (SMCR) was first rolled out to banks in 2017. It will be extended to the rest of the UK financial services sector from 9 December 2019. Clifford Chance has leveraged the insights gained through advising banks on their SMCR implementation to develop the SMCR Manager, a compliance workflow product that will guide users through the application of SMCR and provide ongoing support for compliance following implementation.

For further information please visit www.cliffordchance.com/smcr or smcr@cliffordchance.com.

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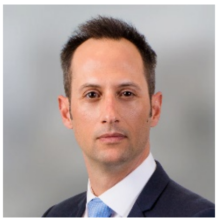

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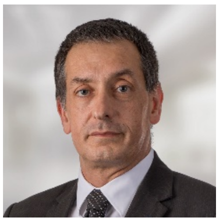

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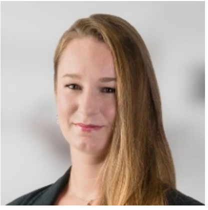

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