

Private Funds Event

November 16, 2015

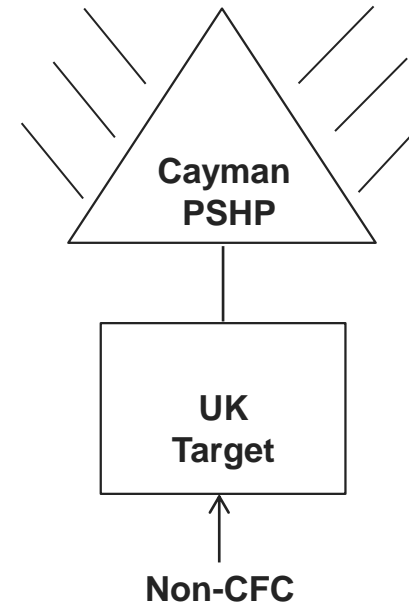
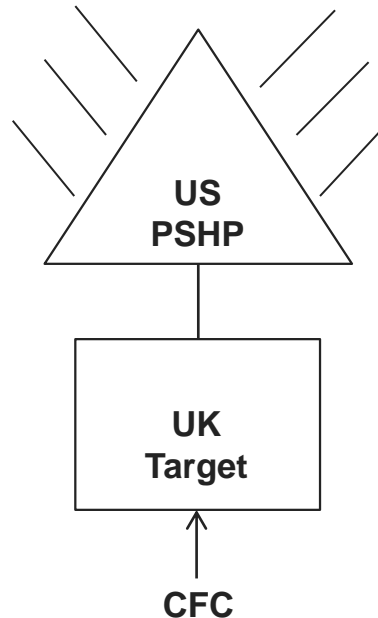


Select Cross Border Tax Issues in Funds :US Sponsored Funds Investing in Europe, Non-US Persons Investing in US Funds

Joan Arnold



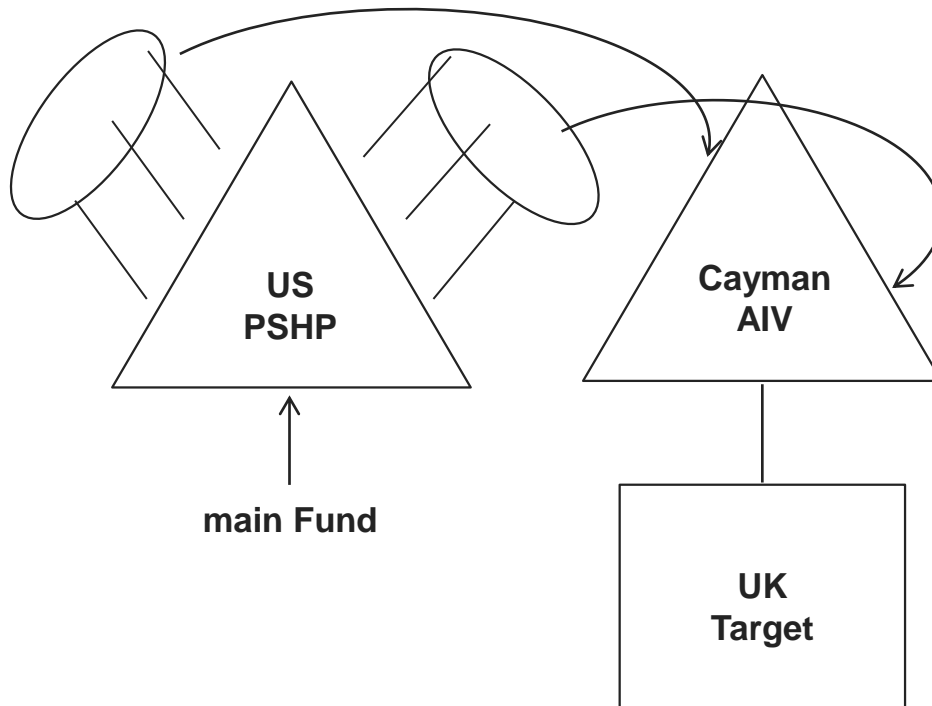
Managing Controlled Foreign Corporation Status



- ▶ Assume partners are diversified and there are not 5 or fewer partners who are US persons who own, in the aggregate, more than 50% of the Fund
- ▶ CFC status can result in the income of the portfolio company being included in the Fund's income before portfolio company receives cash – phantom income to US partners. Exit can result in dividend income, not capital gains.

Managing CFC Status

- Use AIV for non-US investments



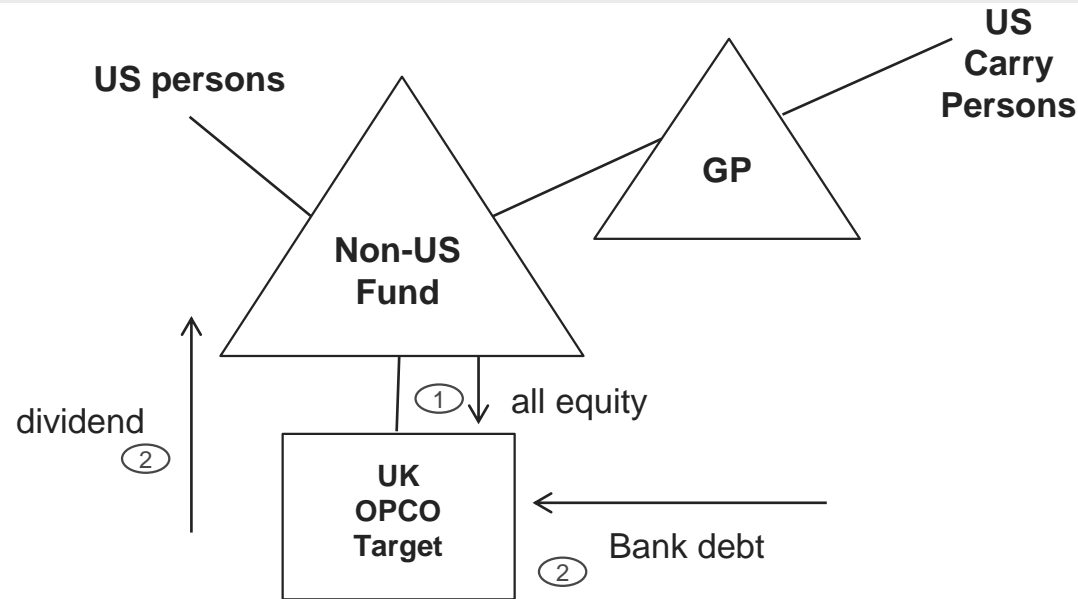
- Capital called into Cayman AIV

Planning for a Partial Exit of Non-US Investment

At stake

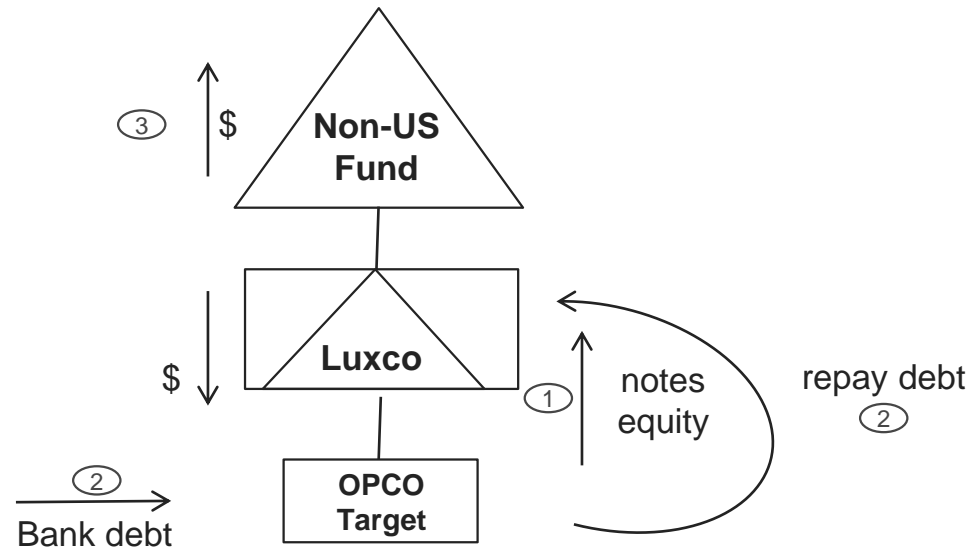
- ▶ Tax free return of capital vs dividend treatment
- ▶ Qualified vs non-qualified dividend
- ▶ Non-US withholding taxes

Base Line



- ▶ Likely a taxable dividend to US persons, if Opco Target has earnings
 - Tax rate 20% if Opco is resident in treaty county
 - Tax rate 39.5% if Opco not resident in treaty county
- ▶ Unless Opco is UK resident, dividend likely subject to host county withholding taxes
 - Difficult to claim treaty benefits to reduce withholding taxes

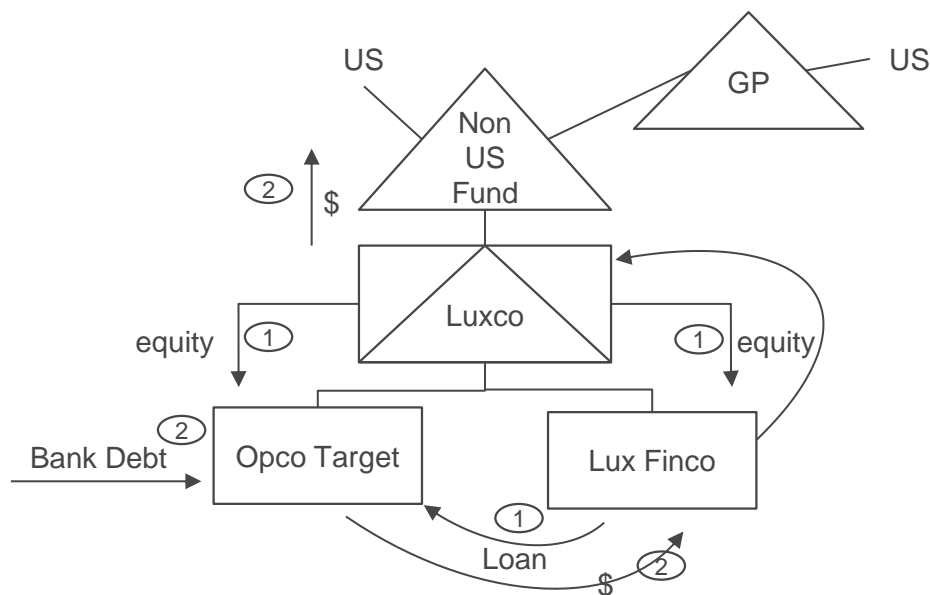
Better Structure



- ▶ Opco repays the notes to Luxco
 - Likely no withholding tax in host county
 - Non-taxable return of principal for US tax purposes
 - Luxco can redeem alphabet shares so no Luxco withholding on cash distributed to Fund
- ▶ Luxco accrues interest income over life of notes, and US persons had phantom income over life of notes

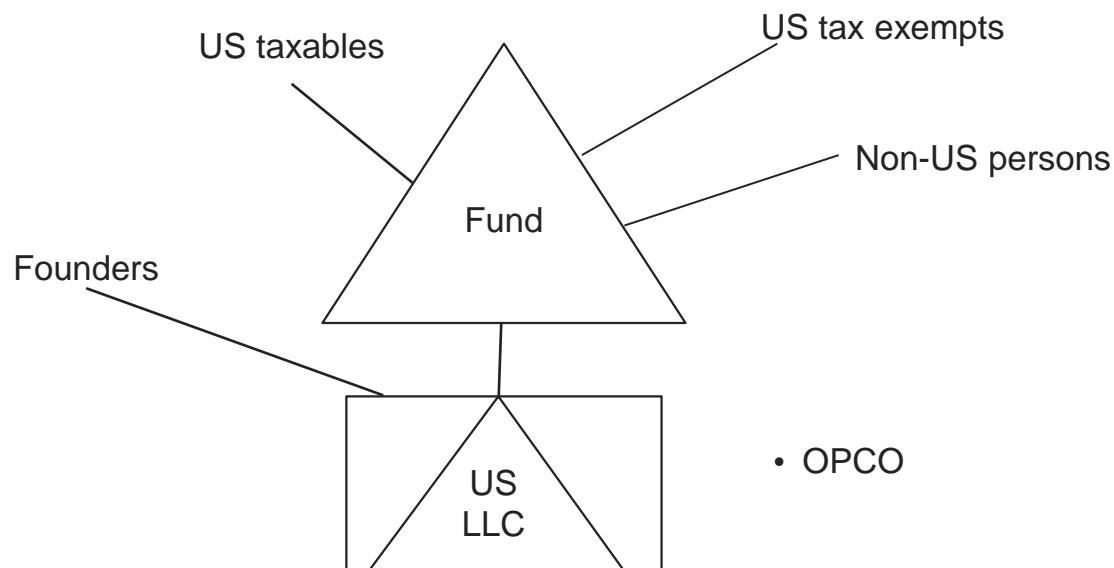
(Assumes Opco's not a CFC)

Better Yet Structure



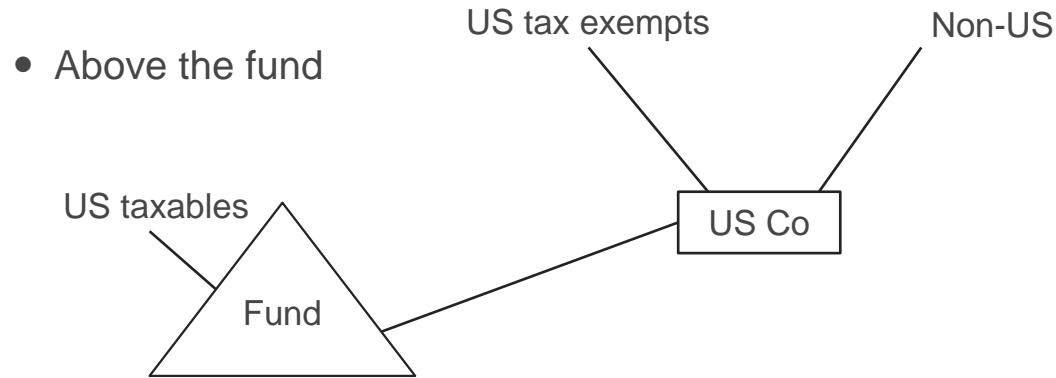
- ▶ Finco is a “closed” entity, so interest accrual is blocked at Finco.
- ▶ Opco pays off Finco loan. Finco redeems its equity held by Luxco.
 - Luxco has dividend to the extent of the accrued interest, remainder is tax free return of basis.
 - Same result as in prior slide, but yield isn’t taxed until there is cash received.

Funds Investing in US LLCs



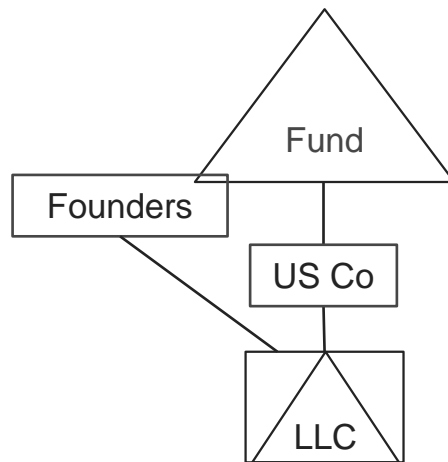
- ▶ US LLC is a tax partnership, so income and loss are passed through to the Fund, and from the fund to its members
- ▶ US tax exempts earn unrelated business taxable income, which may be precluded under fund documents
- ▶ Non-US persons are required to file US tax returns and pay US taxes
- ▶ Fund is required to pay the US estimated taxes on income allocable to Non-US persons

Blocker Menu



- Blocks every investment, not efficient

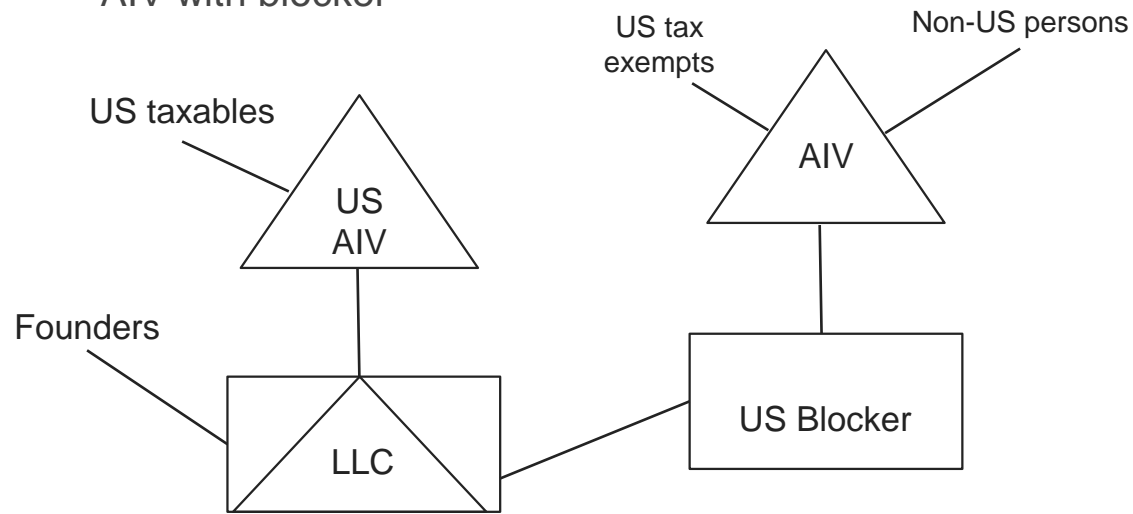
- Below the fund



- Blocks all investors, not tax efficient for US investors

Blocker Menu

- AIV with blocker



- Need to layer in GP interests so GP carry is not blocked
- Need to replicate structure for each LLC investment

NOVEMBER 16, 2015

The extra-territorial impact of EU regulation

Richard Small & Katherine Dillon

AGENDA



- **Marketing of funds under the AIFMD**
- Change in control and asset stripping
- Short selling
- AIFMD Remuneration
- Brexit – the day after tomorrow

MARKETING OF FUNDS UNDER THE AIFMD

Background



- The Alternative Investment Fund Managers Directive (AIFMD):
 - applies to managers of alternative investment funds (AIF);
 - obliges EEA based managers to become authorised;
 - creates a regulatory framework for authorised managers; and
 - affords EEA managers a pan-European passport to market their funds.
- An AIF is a collective investment undertaking which:
 - **raises capital;**
 - from **a number of investors;**
 - with a view to investing it in accordance with a **defined investment policy** for the benefit of those investors; and
 - is not a UCITS fund.

MARKETING OF FUNDS UNDER THE AIFMD

Marketing



- Non-EEA managers may only market to investors in the EEA via the existing national private placement regimes (NPPR) provided:
 - the manager complies with certain **disclosure requirements**;
 - cooperation agreements are in place between authorities of the jurisdiction of establishment of both the non-EEA manager and non-EEA fund and the EEA jurisdiction being marketed into; and
 - the jurisdiction of establishment of both the non-EEA manager and non-EEA fund are not blacklisted by FATF.
- Marketing includes **direct marketing** by the non-EEA manager and any **indirect marketing** caused by such manager (i.e., via a placement agent).

MARKETING OF FUNDS UNDER THE AIFMD

Third country disclosure requirements / Depositaries



- Non-EEA managers are required to comply with the following disclosure requirements:
 - an annual report to be prepared within six months of the end of the fund's financial year and made available to investors (the annual report should include remuneration information);
 - the AIFMD wrapper to be made available to potential investors before they invest;
 - periodic reporting to investors in relation to, *inter alia*, changes to maximum leverage and total leverage employed by the fund; and
 - annual, semi-annual or quarterly private reporting to the regulator in each jurisdiction into which the manager is permitted to market the fund.
- Some jurisdictions (Germany, Austria, Denmark) require non-EEA managers to appoint a depositary-lite in respect of each non-EEA fund being marketed.

MARKETING OF FUNDS UNDER THE AIFMD

Notification v Registration



- **Notification:** a straight-forward notification regime – as soon as the notification has been submitted, marketing can begin. (The UK and the Netherlands)
- **Registration:** effective pre-approval from the local regulator, this can take several months or longer. (Finland and Sweden)
- **Registration & depositary:** in addition to effective pre-approval, a depositary-lite must be appointed on behalf of the fund being marketed (and in some instances the related master fund in a master-feeder structure). (Germany and Denmark)

MARKETING OF FUNDS UNDER THE AIFMD

Reverse inquiry / Passive marketing



- Genuine reverse inquiry is outside of the scope of the AIFMD.
- Different member states have different definitions of reverse inquiry (i.e., in some the specific fund must be requested by name).
- Manufactured reverse inquiry is not acceptable.
- Letter of attestation from investor (and placement agent where relevant).
- Reverse inquiry is not a marketing strategy!

MARKETING OF FUNDS UNDER THE AIFMD

Soft marketing



- Soft marketing – approaching prospective investors with pitch books / draft documentation (without subscription documents) – generally not regarded as AIFMD marketing.
- But estops managers from later relying on reverse inquiry.
- Trend towards managers using soft marketing to gauge interest in a particular jurisdiction before incurring cost and effort of notification / registration.
- Devil in the details – local advice should always be taken before conducting soft marketing – very jurisdiction specific interpretation.

AGENDA



- Marketing of funds under the AIFMD
- **Change in control and asset stripping**
- Short selling
- AIFMD Remuneration
- Brexit – the day after tomorrow

CHANGE IN CONTROL

Background



- Persons gaining or increasing control through a controller band over a UK authorised firm are required to obtain prior approval from the appropriate regulator.
- The “control” concept for these purposes goes beyond the ordinary meaning to encompass interests of 10% and upwards.
- NB: contrast with the definition of “control” under AIFMD (>50%) and UK/EEA takeover rules (>30% in UK).
- EEA-wide regime (which is currently under review at EEA level in an effort to harmonise) but focus today on UK specifics given national variation.

Change in control

Scope of UK regime



- Who? (Target firms)
 - All UK authorised firms, subject to few exemptions.
- Who? (Controllers)
 - All controllers or prospective controllers (UK based or otherwise).
 - Controller includes any person, who (directly or indirectly):
 - holds 10% or more of the shares in a target firm (“T”) or its parent (“P”);
 - holds 10% or more of the voting power in T or P; or
 - hold shares or voting power in T or P as a result of which that person is able to exercise significant influence over the management of T.
- “Acting in concert”
 - if two or more persons exercise the rights linked to their holdings in accordance with an explicit or implicit agreement between them, their holdings must be aggregated for purposes of determining control.

CHANGE IN CONTROL

Acquiring, increasing and reducing control



- **Acquiring or increasing control:** a person who decides to acquire control over a UK authorised firm must give the regulator notice and receive prior approval of the acquisition **before proceeding**. The same applies if an existing controller decides to increase control through a controller band.
- **Time frame: 60 working days** from the date regulator acknowledges receipt of a complete notification. The 60 working days period may be interrupted if additional information is required.
- **Reducing or ceasing control:** regulator must be notified if an existing controller reduces control through a controller band or ceases to have control altogether.
- **Payment Services Firms:** 28 days notice for changes (no positive approval required though regulator of course has power to object).

CHANGE IN CONTROL

Controller Bands



- Controller bands:
 - 10% or more, but less than 20%;
 - 20% or more, but less than 30%;
 - 30% or more, but less than 50%; and
 - 50% or more.
- Significant influence.
- Changes in holdings within a controller band: no prior approval needed.
- NB: certain firms (general insurance intermediaries, consumer credit)
 - single band of 20% or more.

CHANGE IN CONTROL

Common issues with identifying changes in control



- “Shares” and “voting power” in non-standard structures.
- Significant influence (board influence, decision-making).
- Parent “undertakings”.
- Restructuring scenarios:
 - Intermediate holding companies (must always be approved even if no new “external” control);
 - Rights issues, debt for equity swaps, etc.; or
 - Quasi-control rights for Lenders/funding parties.
- Partnerships
 - New or departing limited partners (smaller partnerships); or
 - New general partners.

CHANGE IN CONTROL

Assessment Procedure



- Prescribed PRA/FCA forms.
- Information / supporting documents required:
 - Pre and post-transaction structure charts;
 - CVs for individual controllers and directors/members of corporate controllers;
 - proof of funding;
 - for corporate controllers, accounts for the last three financial periods; and
 - if controller to become a parent undertaking of the target or its parent, a full business plan.
- Consider implications of statements
 - Criminal liability for false statements; and
 - “Commitments” re future strategy, funding, etc.

CHANGE IN CONTROL

Controller Assessment Criteria



- Reputation of Controller.
- Reputation and experience of Target firm's future directors or equivalent.
- Financial soundness of Controller:
 - taking into account nature of Target firm's business.
- Ability of Target to comply with prudential requirements:
 - Conditional approvals have tended to be capital-related.
- Where Target firm will be integrated into Controller's Group, impact on supervision:
 - Consider particularly for cross-border groups.
- Any reasonable grounds for suspicion of money laundering or terrorist financing.

CHANGE IN CONTROL

Fitness and propriety



- **Initial application forms** – extensive “bad boy” disclosures, including:
 - criminal offences, disciplinary/regulatory investigations;
 - litigation/judgements; and
 - prior involvement with insolvent companies.

CHANGE IN CONTROL

Fitness and propriety cont.



- **Changes to circumstances** of existing Controllers:
 - significant deterioration in financial position;
 - litigation/investigations that “might question integrity”;
 - cessation of overseas authorised status;
 - significant change in board composition;
 - consider the general principal question: would the regulator expect notice; and
 - note that the obligation to notify the regulator of changes to circumstances rests with the UK authorised entity and not with the Controller.

CHANGE IN CONTROL

Sanctions



- Failure to notify regulator / obtain prior approval is a criminal offence:
 - potentially unlimited fine; and/or
 - persons proceeding with acquisition / increase in control after the regulator has objected to their application may also be imprisoned for a term of up to two years.
- Restriction notices and orders for sale of shares:
 - regulator may impose restrictions on shares or voting power that have been improperly acquired, including restrictions on transfer, exertion of voting rights and payment of dividends; and/or
 - regulator may also apply to the court for an order for the sale of shares or the disposition of voting power in some circumstances.
- Examples are rare but have increased in recent years.

AIFMD: PORTFOLIO COMPANIES

General



- Alternative Investment Fund Managers Directive (AIFMD)
- Applies to managers of alternative investment funds (broadly all non-UCITs funds), including US/other non-EEA managers marketing funds into the EEA.
- Restrictions apply where the fund manager acquires substantial stakes in EEA private companies:
 - Acquiring 10% or more = basic disclosure obligations to Regulators.
- Acquiring “control”: more extensive obligations:
 - substantial disclosure obligations to regulators, the company, shareholders and employees; and
 - 2 year anti-asset stripping prohibition.
- Note: thresholds and procedures for EEA listed companies are slightly different and may vary by member state.

ACQUIRING EU PORTFOLIO COMPANIES

Notifications and Company engagement



- Regulatory disclosure obligations where funds (individually/jointly) acquire “major holdings” in EEA companies.
- Interests of 10% and upwards (voting only):
 - basic disclosure obligations to Regulators (private); and
 - further notification obligations apply above/below 20%, 30%, 50%, 75%.
- Acquiring “control” (>50%) requires substantial disclosures:
 - must notify regulators, the company, shareholders and (indirectly) employees, covering:
 - details of controlling shareholders and acquirer group structure; and
 - intentions regarding the future business, including repercussions/material changes for employees.

AIFMD: ASSET STRIPPING

Article 30 AIFMD



- Article 30 of the AIFMD prohibits “asset stripping”.
- Managers of AIFs who:
 - individually or jointly;
 - acquire control of a non-listed company or issuer;
 - may not for a period of 24 months following acquisition of control of the entity;
 - engage in “asset stripping” in relation to that entity.
- Exclusions:
 - SMEs (<250 employees and below financial thresholds); and
 - real estate SPVs (but not SPVs generally).

AIFMD: ASSET STRIPPING

Asset stripping defined



- Asset stripping defined as:
 - facilitating, supporting or instructing any distribution, capital reduction, share redemption and/or acquisition of own shares by the company; and
 - to the extent that the manager is authorised to vote on behalf of the fund at the meetings of the governing bodies of the company, voting in favour of a distribution, capital reduction, share redemption and/or acquisition of own shares by the company.
- Anti-avoidance: manager is required to use its best efforts to prevent distributions, capital reductions, share redemptions and/or acquisitions of own shares by the company.
- Shareholder loans not referenced – workarounds?

AGENDA



- Marketing of funds under the AIFMD
- Change in control and asset stripping
- **Short selling**
- AIFMD Remuneration
- Brexit – the day after tomorrow

SHORT SELLING

Overview of extra-territorial application



- **Private disclosure** to regulator of net short positions in:
 - shares;
 - sovereign debt; and
 - uncovered positions in sovereign CDS (where restrictions otherwise lifted).
- **Public disclosure** of net short positions in shares.
- **Exemptions** for:
 - shares where principal trading venue is in a third country;
 - market makers; and
 - primary dealers (sovereign debt).

SHORT SELLING

Overview of EEA only application



- Restriction on uncovered shorts of shares and sovereign debt:
 - borrow;
 - agree to borrow; and
 - locate.
- Prohibition on naked CDS (with disclosure to regulator where restriction temporarily lifted).

SHORT SELLING

Long and short positions



- A **short position** in shares / sovereign debt is defined as:
 - a short sale of a share or sovereign debt instrument; or
 - entering into a transaction the effect of which is to confer a financial advantage on the person entering into that transaction in the event of a decrease in the price or value of the share or debt instrument.
- A **long position** in shares / sovereign debt is defined as:
 - holding the share or sovereign debt instrument; or
 - entering into a transaction the effect of which is to confer a financial advantage on the person entering into that transaction in the event of an increase in the price or value of the share or debt instrument.
- Note that **swaps** (derivatives in European parlance) must be included in the calculation.

SHORT SELLING

Disclosure of net short positions in shares



- **Private disclosure** to local regulator
 - trigger at 0.2% of issued share capital; and
 - each incremental 0.1% thereafter.
- **Public Disclosure**
 - trigger at 0.5% of issued share capital; and
 - each incremental 0.1% thereafter.

SHORT SELLING

Disclosure of net short positions in sovereign debt



- **Private disclosure** to local regulator (of issuer).
- **Initial triggers** at:
 - 0.1% of outstanding issued sovereign debt if less than €500 billion; and
 - 0.5% the outstanding issued sovereign debt if above €500 billion.
- No **public disclosure** of net shorts in sovereign debt.

SHORT SELLING

Methodology of disclosure



- Netting of long and short positions, but records of gross positions must be kept for at least five years.
- Net end of day (midnight) calculation time.
- Notification by 15:30 local time of relevant regulator on next trading day.
- Some regulators require pre-registration before notification can be made – this can take some time!

AGENDA



- Marketing of funds under the AIFMD
- Change in control and asset stripping
- Short selling
- **AIFMD Remuneration**
- Brexit – the day after tomorrow

AIFMD: REMUNERATION

Background



- AIFMD imposes prescriptive remuneration rules on EEA managers.
- Non-EEA managers are mostly excluded but must comply with disclosure rules for Annual Fund Reports.
- Annual Fund report requires disclosure of:
 - total annual remuneration paid to in-scope staff at the manager (on an aggregate basis only); and
 - high-level qualitative information regarding remuneration policy and procedures.

AIFMD: REMUNERATION

What?



- “Remuneration” is broadly defined to include all payments or other benefits paid by or on behalf of the manager or the AIF to in-scope staff, including:
 - cash payments;
 - shares or equivalent distributions;
 - other in-kind benefits; and
 - carried interest, where paid as compensation for management.
- Covers both fixed and variable payments.
- Excludes payments made in realisation of return on investment (as opposed to paid as compensation for management or other services).

AIFMD: REMUNERATION

Who?



- Staff in scope of the rules:
 - senior management;
 - control functions (portfolio management, administration, human resources and marketing heads);
 - other material "risk takers" (e.g., individual portfolio managers); and
 - staff receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers and with potential for material impact on the risk profiles of the fund or fund manager.

AIFMD: REMUNERATION

How?



- Annual fund report for AIFs marketed into EEA requires disclosure of:
 - balance sheet/financial statements and activities report;
 - updated investor marketing information; and
 - aggregate remuneration details (most sensitive piece).
- Provided to regulators and investors on request.
 - (May become effectively public).
- Within six months of the fund's financial year end.

AIFMD: REMUNERATION

The details



- Remuneration disclosures must cover:
 - total annual remuneration paid by the fund manager to its staff for the financial year;
 - number of beneficiaries;
 - split into fixed and variable remuneration, including, where relevant, any carried interest; and
 - split by senior management and material risk takers.
- Disclosures at individual fund or fund manager level?
 - Some flexibility (for now) – but scope must be clear.
 - If disclosed for the manager as a whole, information should be broken down by funds (where practicable).

AIFMD: REMUNERATION

Sanctions



- Sanctions for non-compliance:
 - Set at individual member state level.
- May include:
 - regulatory directions/interventions;
 - fines;
 - ban on marketing to local investors;
 - public censure;
 - “grassing up” to SEC or other regulators; and
 - (in some cases) criminal sanctions.

AGENDA



- Marketing of funds under the AIFMD
- Change in control and asset stripping
- Short selling
- AIFMD Remuneration
- **Brexit – the day after tomorrow**

BREXIT

Background



- There are 28 member states in the European Union, including the UK.
- All EU members and a further three European countries (Norway, Iceland, Liechtenstein) are members of the EEA.
- Switzerland is not a member of either but is part of the European Free Trade Association (EFTA).

BREXIT

The Brexit referendum



- The British government has committed to an in-out referendum on the UK's membership of the European Union (the so-called British exit or "Brexit") by the end of 2017
- The driving forces behind the referendum include:
 - intra-EU immigration concerns and the payment of social security to nationals of other EU member states (known as benefit tourists);
 - the perception that Brussels is imposing ever increasing regulation / red tape on British business, particularly in the financial services sector;
 - ever closer EU member state political and economic integration and a fear that those outside the Eurozone are increasingly powerless to block unwanted regulation; and
 - the recent migrant and Euro crisis having a negative impact on the UK.

BREXIT

The options



- A Brexit could potentially take one of five different forms:
 - **Norway option:** remain a member of the EEA but lose the ability to influence EU law-making (this seems an unlikely outcome);
 - **Swiss option:** join EFTA to preserve limited ties with the EU but require the negotiation of new bilateral agreements;
 - **Turkey option:** form a customs union with the EU;
 - **WTO option:** rely on WTO membership; or
 - **Bilateral option:** negotiate new bilateral trade agreements with the EU.
- Depending on the option taken, the UK would need to negotiate the appropriate bilateral agreements with third (non-EEA) countries such as the United States on an *ad hoc* basis. The US appetite for bilateral agreements with the UK will likely turn on the then White House incumbent and Congress/Senate.

BREXIT

When? Scotland?



- The referendum must be held by the end of 2017.
- The transition process on a leave vote would likely take at least two years.
- The UK's membership of the EU includes England, Wales, Northern Ireland and Scotland.
- Scottish leaders are generally pro-EU membership – a leave result in the UK EU referendum would likely trigger a second Scottish independence referendum.
- A leave result in the (second) Scottish independence referendum would likely see Scotland having to re-apply for EU membership (although this time around the response from Brussels and other EU member states would likely be more welcoming).

BREXIT

Impact for US financial institutions



- **If the UK remains in the EEA** there will, in practice, be little change for US financial institutions as they will be able to continue using the pan-EEA passport.
- **If the UK does not remain in the EEA**, then:
 - the passporting regime would be unavailable, which would reduce the efficacy for US institutions of using the UK as a "hub" to access wider EU/EEA markets;
 - some international banks have indicated that they would consider moving European headquarters elsewhere - although this could bring its own difficulties; and
 - US investment managers seeking access to UK investors post-Brexit may still face restrictions similar to the MiFID and AIFMD regimes currently in force, as the UK would likely keep their implementation of these EU directives on the statute books for the "equivalence" reasons.

BREXIT

Other macro level considerations



- International trade agreements (including reciprocal taxation arrangements) would need to be renegotiated with the UK on an individual basis.
- Credit ratings of the UK Government and UK institutions may change.

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