DUFF & PHELPS

Protect, Restore and Maximise Value

Regulatory Focus

Issue 128

In this edition of Regulatory Focus, the experts in Duff & Phelps' UK Compliance and Regulatory Consulting team, provide a detailed synopsis of the latest news and publications issued by the Financial Conduct Authority (FCA) during August 2019.

INSIDE

Senior Managers and Certification Regime Toolkit

We now have less than **100 days** to go until SM&CR is implemented on 9th December 2019. SM&CR will affect every FCA solo regulated firm, so all firms should be preparing for the new regime and considering the impact on their firm and on individuals. Firms still have time to implement SM&CR but we encourage firms to start working on this as soon as possible, if they have not already started.

Duff & Phelps can help firms with their SM&CR projects and we can tailor our services to your firm's requirements. Our services include the provision of an SM&CR toolkit that will enable your firm to:

- Manage your **SM&CR implementation** project planning.
- Undertake a mapping exercise from the current Approved Persons Regime to the new SM&CR Regime
- Prepare **Statements of Responsibilities**
- Develop a **reasonable steps framework** for Senior Managers
- Implement new SM&CR procedures, including **New Joiner and Leaver Procedures** for Senior Managers and Certified Individuals
- Conduct **Fit and Proper Assessments**
- Implement the **Certification process**
- Provide guidance on relevant areas, such as the **Duty of Responsibility** for Senior Managers

Our Toolkit covers all the requirements of SM&CR as well as practical guidance on how to apply SM&CR to your business. It is designed for implementation of the new regime to enable firms to be compliant by 9th December and for maintaining compliance on an ongoing basis after that date.

Please let us know if you would like more information about our SM&CR toolkit or would like to discuss further how we can help. We are also happy to provide a demonstration of the toolkit, so you can see how it would work within your firm.

For further information please email jane.stoakes@duffandphelps.com

Brexit – Tax Implications for Asset Managers

The likelihood of the UK leaving the EU on October 31 whether via a "soft" or "Hard" Brexit changes almost daily. As such, managers with cross-border operations should review the tax implications of such an outcome on their structures to ensure they remain tax efficient and do not incur unwelcome tax costs.

Much of the UK tax regime is led by EU legislation and post-Brexit implications of changes to direct and indirect taxes under UK and EU tax law need to be reviewed for group entities. Under a hard Brexit scenario, EU directives will cease to apply. UK businesses will need to rely on double tax treaties in place between the UK and EU countries. Below are some of the key areas of tax-related legislation that will need to be monitored.

- EU laws on the four freedoms: the free movement of goods, services, people and capital;
- The EU Parent Subsidiary Directive that provides relief from withholding taxes on dividend payments made between associated companies in different EU states and provides double taxation relief to parent companies on profits of subsidiary companies;
- The EU Interest and Royalties Directive that relieves withholding taxes on royalty and interest payments between UK companies and associated companies in the EU;
- The EU Merger Directive that provides tax relief on cross-border reorganizations and minimizes tax costs for businesses undertaking merger transactions in the EU; and
- The implications for indirect taxes including VAT, customs duties, excise duties and capital duties (on companies raising capital) on cross-border transactions will need to be considered.

Furthermore, managers may need to restructure their businesses for regulatory purposes (see related article Brexit - Implications for Fund Managers) and establish new EU investment firms, management companies and marketing strategies. Despite the exceptional circumstances, HMRC has publicly stated that it will approach such business restructuring as a result of Brexit no differently to any other corporate event or business change. Therefore, the tax impact of any restructuring as a result of regulatory change and relocation issues relating to the cross-border movement of staff will need to be assessed. Following are some of the key issues investment and fund managers may need to consider for UK tax purposes:

- **Taxation of intangible assets:** The Intangible Fixed Assets (IFA) regime taxes transactions according to their accounting treatment (with certain adjustments) and includes intellectual property, goodwill and other intangible assets for accounting purposes. A transfer of rights under an investment management agreement, realization of brand or trade names, access to IT systems or knowhow as a result of a reorganization could all fall within the IFA regime.
- **Transfer pricing:** Where contracts are transferred as a result of a restructuring, an arm's-length price must be paid for the transaction. Furthermore, businesses will need to review their transfer pricing policy post any restructuring to ensure that intra-group fee flows, and transactions are in line with OECD methodology after the restructuring.
- **Third-party valuation:** Where there is a transfer of tangible or intangible assets between related parties as a result of a restructure, the market value of the asset must be used for the purposes of calculating the tax payable on a disposal and a third-party valuation of the asset may be required.
- **Disposal and goodwill:** Where whole or part of a business is transferred as part of a reorganization, the goodwill associated with that part of the business can also be considered sold. The capital gains tax implications of the disposal of the business and goodwill will need to be reviewed.
- **Corporation tax:** Deductibility of restructuring costs for corporation tax purposes will need to be considered.
- **Loan relationships:** Tax analysis of any changes to loan relationships between parties following a restructuring will need to be reviewed to consider whether these remain on commercial terms and at an arm's-length basis.

Brexit – Tax Implications for Asset Managers

- **Stamp duty:** Businesses will need to consider whether there are any Stamp Duty (SDRT or SDLT) consequences of any restructuring and whether reliefs are available.

- **VAT:** The VAT implications of a transfer upon reorganization (in particular the transfer of going concern rules) and VAT grouping of entities will need to be considered along with the VAT chargeable on resulting provision of services following the restructuring.

- **Investment manager exemption (IME):** Where whole or part of the investment management function is moved outside the UK, consideration would need to be given to whether protection equivalent to the IME will be available in other EU jurisdictions post restructuring.

- **Permanent establishment (PE):** Where individuals have positions with non-UK entities as a result of restructuring, there is a risk that they may be deemed to have a PE in the UK and be subject to UK taxation or vice versa in the EU. This is particularly relevant for entities that may not have any permanent office space or other demonstrable presence outside the UK. Any potential PE risks post restructuring would need to be considered.

- **Anti-avoidance legislation:** Revised business structures may be susceptible to challenge under the complex and extensive anti-avoidance legislation including the Diverted Profits Tax, Profit Fragmentation and other anti-avoidance legislation. Substance requirements where businesses are relocated to non-EU jurisdictions would also need to be considered.

- **International tax legislation:** It is likely that the UK will continue to remain committed to information sharing and disclosure requirements under Directive on Administrative Cooperation (DAC), DAC 6 and the implementation of Anti-Tax Avoidance Directive (ATAD), ATAD2 (which extends the rules to hybrid mismatches) and the OECD report on the Base Erosion and Profit Shifting project along with existing DTAs. Compliance requirements upon reorganization will need to be monitored.

- **Employees:** Employment tax issues arise during the cross-border movement of staff including payroll, PAYE, NIC etc. and these should be reviewed where people are relocated as part of a restructuring exercise.

As the eventual outcome of the Brexit negotiations remains to be determined, these observations will continue to be updated as the political and regulatory approach to Brexit continues to evolve. Duff & Phelps can assist asset managers with reviewing their structures from a tax and regulatory perspective and implement changes in advance of UK's exit from the EU where required.

Upper Tribunal Publishes Decision on Individual

16 August

The Upper Tribunal has found that the former Chief Operating Officer of a wealth management firm breached his obligation as an approved person to act with integrity, in proceedings brought by the FCA. However, the Upper Tribunal determined that the individual's actions did not merit a prohibition order.

In March 2012, the individual received a document containing findings about the culture within a branch of the firm. The firm's chairman then received an anonymous email which alleged a "Wealth cultural audit report" had been suppressed, with the individual helping to draft a response to this allegation.

The Upper Tribunal found that the individual was reckless to give the impression the document did not exist, and that his conduct failed to meet the required standard of integrity.

The Upper Tribunal did not uphold the FCA's allegation that the individual made false or misleading statements to his colleagues, in a response to the US Federal Reserve Bank of New York in November 2012 regarding the same document.

The Upper Tribunal also found that the individual subsequently made a misleading statement to the Institute of Chartered Accountants in England and Wales in relation to their conduct but did not uphold the allegation that the individual had misled the FCA.

A separate hearing on sanctions took place in March 2019. The Upper Tribunal held that the FCA could publish a statement of the individual's misconduct but did not uphold the FCA's submission that a breach of the obligation to act with integrity by a senior manager justified a prohibition order. The FCA has published a final notice.

For more information, please click here.

Information for customers of AFX Markets Limited

27 August

The High Court of Justice of England and Wales appointed special administrators to a brokerage firm following an FCA application for a special administration order.

The UK registered company was authorised by the FCA in May 2012. The firm brokered foreign exchange and contracts for difference products for customers trading on its online platforms. The firm has approximately 1,200 customers and safeguards approximately £7.5m of client money.

The firm acted as an intermediary and trades were executed by its parent company, which held most of client money in the form of margin to secure open positions and cover obligations. The parent company, in Cyprus, had its licence suspended by the Cyprus Securities and Exchange Commission on 19 July 2019.

On 31 July 2019, the FCA required the firm to cease conducting regulated activities unless for closing trading positions and froze the firm's assets due to concerns over its financial position and arrangements for safeguarding client money.

The FCA made a subsequent application to appoint special administrators under the Investment Bank Special Administration Regulations 2011 to the High Court, to reconcile and distribute client money as soon as possible.

CG Recovery Limited were appointed as special administrators of the firm. Once they have assessed the money position of the firm, it will become clearer whether any client money is missing. The FCA considers there will likely be a deficit in client money.

The special administrator's fees will be deducted from the client money and the Financial Services Compensation Scheme will cover client money and distribution costs up to £85,000 for eligible clients.

The FCA advises that claims management companies should be used with caution, stating that there is no benefit for the majority of clients involving a third party and this will incur a fee. Customers are advised to contact the special administrators in the first instance to assist in the return of client money.

The firm remains authorised by the FCA and subject to its supervision.

The full article can be found here.

The European Securities and Markets Authority (ESMA) publishes Guidelines on Liquidity Stress Testing for Investment Funds

2 September

ESMA published final Guidelines regarding liquidity stress testing of Alternative Investment Funds and UCITS funds. Although the Guidelines are applicable to both managers and depositaries of such funds, the majority of the guidelines are applicable to the relevant fund manager

The ESMA Guidelines follow recommendations by the European Systemic Risk Board published in 2018 on liquidity and leverage risk in investment funds.

The Guidelines clarify that Liquidity Stress Testing should:

- Be subject to appropriate governance and oversight, including appropriate reporting and escalation procedures,
- Be carried out at least annually and where appropriate, employed at all stages in a fund's life-cycle,
- Employ hypothetical and historical scenarios and where appropriate reverse stress testing.

The Guidelines also clarify:

- The outcomes in which appropriate Liquidity Stress Testing should result,
- The key factors which Liquidity Stress Testing models should take into consideration in their construction,
- The requirements of a Liquidity Stress Testing Policy.

Fund managers should be able to demonstrate to their regulators that authorised funds' strategy and dealing frequency enable them to remain sufficiently liquid during normal and stressed circumstances.

The Guidelines, which apply from 30 September 2020, should be adapted to the nature scale and complexity of the fund. A link to the Guidelines is available here.

EMIR REFIT as it applies to UK Alternative Investment Fund Managers

What is it?

EMIR Refit amounts to targeted amendments of EMIR that aim to simplify certain existing requirements, particularly in relation to Counterparties which take a **Principal Position**, in **OTC Derivatives**;

1. Counterparty classification;
2. Clearing; and
3. Trade Reporting requirements.

This article comments on the application of EMIR Refit to entities which manage Alternative Investment Funds (AIF) in the UK.

Counterparty Classification

EMIR Refit clarifies, amongst other things, the definition of a Financial Counterparty (FC) as it relates to Alternative Investment Funds (AIFs) and their Managers' obligations. It also highlights Non-Financial Counterparties (NFC) which are defined below and sub-divides both FCs and NFCs into those which exceed the Clearing Threshold (FC+/NFC+), and those which do not (let's call them FC-/NFC-.)

The obligation on, and extent to which, Clearing and Trade Reporting apply depends on whether the Counterparty is an FC or an NFC and whether they are above or below the Clearing Threshold.

An **AIF** will be a **Financial Counterparty** if it is;

1. An **EEA AIF** Managed by a;
   a. Non-EEA AIFM;
   b. Full Scope UK AIFM;
   c. Small Authorised UK AIFM; or
   d. Registered UK AIFM; additionally
2. A **Non-EEA AIF** Managed by a;
   a. Full Scope UK AIFM;
   b. Small Authorised UK AIFM; or
   c. Registered UK AIFM.

Non-Financial Counterparties are;

3. Any Counterparty to the derivative trade which is not a Financial Counterparty.

Clearing Thresholds for FCs and NFCs

For both Financial Counterparties (FCs) and Non-Financial Counterparty (NFCs);

a. **FC+ or NFC+** respectively are those which exceed the Clearing Threshold defined as follows: A counterparty will calculate their Average Aggregate Notional Amount (AANA), meaning their outstanding gross notional contract value will be categorised in each of the following Assets traded on a month end average, over the past 12 months, at or above;
   i. €1bn OTC Credit Derivative Contracts; or
   ii. €1bn OTC Equity Derivative Contracts; or
   iii. €3bn OTC Interest Rate Derivative Contracts; or
   iv. €3bn OTC Foreign Exchange Derivative Contracts; or
   v. €3bn for OTC Commodity Contracts and all other Classes of OTC Derivatives Combined.

If any one of these Asset Class thresholds are breached the counterparty will be either an FC+ or NFC+ which applies on all in scope OTC Derivative transactions (i.e. including those asset classes where the Threshold has not been breached);

NOTE – An NFC can exclude hedging and treasury financing transactions from its calculation. A FC has no such exclusions.

b. An **FC- or NFC**- counterparty is one that falls below the Clearing Threshold described above.

Clearing Obligation

The Clearing Obligation under Article 4 of EMIR requires that only certain OTC Derivative contracts will be subject to mandatory central clearing and must be cleared through an EMIR EEA Authorised, or Non-EEA Recognised, Central Counterparty (CCP.)

ESMA's Public Register provides the up to date status of which OTC derivatives are currently mandated for clearing.

To view the register, click here

EMIR REFIT as it applies to UK Alternative Investment Fund Managers

The extent to which a Financial Counterparty, e.g. an AIF as defined above, is subject to the Clearing Obligation depends on the status of the Financial Counterparty. If;

1. The AIF's Manager does not undertake the following AANA calculations for each of its AIF Managed, the AIF is subject fully to the Clearing Obligations;
2. The AIF's Manager does undertake the following AANA calculations, based on **all OTC Derivatives Traded** on a month end average over the last 12 months of or more than;
   a. €1bn OTC Credit Derivative Contracts; or
   b. €1bn OTC Equity Derivative Contracts; or
   c. €3bn OTC Interest Rate Derivative Contracts; or
   d. €3bn OTC Foreign Exchange Derivative Contracts; or
   e. €3bn for OTC Commodity Contracts and all other Classes of OTC Derivatives Combined; **then**;
3. **The Small Financial Counterparty Exemption** applies; if none of the Thresholds have been breached, then the **Clearing Obligation does not apply**, meaning the AIF is an FC-.

Equally for NFCs, the Clearing Obligation will only apply to counterparties that exceed the Clearing Threshold (NFC+). AIF, as defined above, cannot be an NFC but it is important to be aware they can be facing an NFC.

AANA Calculation and Clearing Notification to the AIF's NCA (e.g. FCA) and to ESMA

ESMA has indicated that if an AIF wishes to rely on the above Small Financial Counterparty Exemption above, it must have performed its AANA calculation as at the date EMIR Refit came into force, 17 June 2019. ESMA has also stated that FCs and NFCs can choose whether to conduct the AANA calculation.

Question 3 from the ESMA EMIR CCP and Trade Repositories Q&A elaborates.

Where the counterparty chooses to calculate the AANA, this will mean providing the outstanding non-cleared OTC derivative gross notional value for each of the asset classes; credit, interest rates, equity, foreign exchange and commodities including 'others.' Calculation is done on an annual basis, showing the aggregate month end average position in OTC contracts.

FCs should perform the calculation for all OTC derivative transactions entered into by the group to which the FC belongs. However, for UCITS and AIFs, the calculation is performed at a fund level.

Derivatives executed on non-EU exchanges that are equivalent to a regulated market don't count towards the clearing threshold (but may be subject to clearing rules/regulations of that particular jurisdiction). OTC derivatives executed on other (non-equivalent) exchanges do count towards the clearing threshold.

ESMA publish a list of third country exchanges that are deemed equivalent, and the latest version can be found here.

When a counterparty chooses not to perform the calculation, or where the result of that calculation exceeds the clearing thresholds, then the counterparty (whether FC or NFC) is required to immediately notify ESMA and their own NCA.

In addition, the FC subsequently becomes subject to the Clearing Obligation for all in-scope Asset Classes of OTC Derivative Contracts entered into, or novated, from four months following that notification.

NFCs have a further incentive to conduct the calculation, as they become subject to the Clearing Obligation **only** for the in-scope Asset Classes of OTC Derivative Contracts under which they exceed the Clearing Threshold.

Trade Reporting

EMIR Trade Reporting applies to all EEA counterparties. FCs, i.e. including in-scope AIF and NFCs that are principle to a derivative transaction, will need to report the transaction to a Trade Repository.

It is important for FC's to be aware that, as of June 2020, where an FC executes a transaction facing an NFC-, the obligation to report now lies with the FC. Therefore, in scope AIFs, being now defined as FCs, will need to prepare for this change in reporting obligation by June 2020. An NFC- will be required to provide any mandated information to the FC to allow the FC to properly report.

MiFID II: ESMA makes new bond liquidity data available

1 August

ESMA has confirmed that new quarterly liquidity assessment data for bonds trading on EU trading venues will be published on its data register. There are 594 liquid bonds subject to Markets in Financial Instruments Directive (MiFID) II transparency requirements for the current period.

To assist market participants to know whether a bond should be considered liquid or not ESMA publishes quarterly liquidity assessments. The liquidity assessment for bonds is based on a quarterly assessment of quantitative liquidity criteria, which include the daily average trading activity and percentage of days traded per quarter. The full list of assessed bonds will be accessible through ESMA's Financial Instruments Transparency System and the Register web interface. ESMA is also publishing two completeness indicators relating to bond liquidity data.

Transparency requirements for bonds deemed liquid as of 1 August will apply from 16 August to 15 November 2019.

The full article can be found here.

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OUR RECENT AWARDS

BEST FINANCIAL SERVICES TAX PRACTICE
Tolley's Tax Awards 2019

BEST COMPLIANCE CONSULTANCY
CTA intelligence Awards 2018

ADVISORY AND CONSULTANCY: TAX
Drawdown Private Equity Services Awards 2018

BEST ADVISORY FIRM – REGULATON AND COMPLIANCE
HFM Week 2018

BEST GLOBAL CYBERSECURITY SERVICES PROVIDER
Hedgeweek Global Awards 2018

BEST COMPLIANCE CONSULTING TEAM
Women in Compliance Awards 2017

BEST GLOBAL REGULATORY ADVISORY FIRM
Hedgeweek Global Awards 2017

EUROPEAN SERVICES - BEST CONSULTANCY FIRM
CTA Intelligence 2016

BEST EUROPEAN OVERALL ADVISORY FIRM
HFM Week 2016

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