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The UCITS IV directive: what opportunities for management companies?

The draft AIFM directive has stirred so much commotion among fund managers that the entry into force in just one year[1] of the «*OPCVM IV*" directive, most commonly referred to as the UCITS IV directive, could have gone unremarked.

Yet this Directive is likely to offer portfolio management companies new opportunities. Recommendations made by the French Market Committee suggest that this is the case; they were submitted for consultation until the end of June[2].

These 14 recommendations break down into two key categories, those regarding the players, the management companies, and their products, the UCITS.

1/ The recommendations applicable to management companies aim to:

- **Enable management companies to diversify their activities**

- To date, the AMF has deemed that portfolio management companies may not render certain services, including investment services. The French Market Committee recommends that this should change.

- **Facilitate recourse to providers:**

- to whom the management companies delegate financial management. A management company would henceforth be authorised to use the services of an assignee, even when it does not possess the equivalent means of those of the provider.

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[1] On July 1, 2011

[2] http://www.amf-france.org/documents/general/9431_1.pdf

- and, in particular, to investment advisors located outside the European Union. When a management company requires help to make investment decisions, it may call upon consultants located in the places in which the company intends to make its investments. Current provisions in the MiFID relating to investment advice prohibit entities located outside the European Union from providing advice.

- **Reduce the formalities involved in creating and developing a portfolio management company:**

- Setting up and obtaining approval for a management company is currently a long, relatively complicated process. The French Market Committee wishes to simplify approval procedures and business programmes by focusing them on the key elements.

- The information that a management company must declare or submit to the AMF (Financial Market Authority) when its business or organization changes are particularly numerous, generating significantly high administrative costs. The current organization of this process will therefore be re-examined.

2/ The recommendations concerning their products aim to:

- **Reduce the formalities involved in creating and developing UCITS**

- In principle, forming and marketing a fund requires drawing up a simplified prospectus. This document should be replaced by a key information document (a "KID"), trimmed down to essentials and standardised for all coordinated European UCITS.

- Similarly, whenever a UCITS changes, the management company may be required to inform each individual unit holder, a formality that often appears disproportionate, useless and costly. For this reason, the information sent to unit holders would be reviewed, reducing it to a strict minimum. Information sent to individuals would be required only when the planned changes were in fact substantial. For any other modifications, unit holders could be informed by simple methods (e.g. by e-mail).

- **Foster the marketing of foreign funds**

- The aim of the UCITS IV directive is to make it easier to market European funds within the Union. The management company would no longer be required to notify its authorization to market a UCITS in another member state; this procedure would be carried out by the regulator of the country in which the fund is domiciled.

- The possibility of setting up dedicated funds or feeder funds which are 100% invested in master funds (in particular, foreign funds) is complicated given the AMF's interpretation of the management company's autonomy principle. This interpretation would be reviewed in order to allow such funds to be set up.

- **Secure the distribution and preservation of fund assets**

- No single legal framework exists in France for the distribution of financial products. Instead, a host of overlapping regulations place responsibility on highly varying individuals: canvassers, financial investment advisers, investment consultants, placement agents, etc. The idea would be to clarify and harmonize the rules, and even to create a single status.

- Absence of harmonization of the role, duties and responsibility of the custodian at the European level is a considerable obstacle to the French stock market's competitiveness, since the depositary's responsibility is less strictly defined than in many other countries.

- **Extend the carried interest tax regime to all UCITS.**

Legal News

The professional certification system came into force on July 1, 2010. Are you prepared to assume your new obligations?

The professional certification system is nothing new, having entered French law more than one year ago. Yet many professionals seem not to be well informed about the new obligations incumbent upon them since July 1, 2010, when the new system came into force. Here is a summary:

- <u>The system's aim</u>

This system aims to oblige investment service providers, including portfolio management companies, to see to it that the individuals under their authority or acting on their behalf possess the appropriate qualifications and expertise as well as sufficient knowledge of the subject.

- <u>How knowledge levels are to be tested</u>

To ensure that these individuals possess the necessary qualifications, investment service providers may choose one of the following methods:

- either conduct an internal assessment using a procedure which the AMF can check;
- or require staff members to pass a certified external examination.

The advantage of the second solution is that a person who has passed the certified examination no longer needs to undergo an internal assessment. With the results of this examination, this person can change companies without having to undergo any further assessment.

Only certain organizations approved by the AMF are authorized to give certified examinations and pass candidates.

- The people involved

Not all employees of management companies or those who provide them with certain services are required to take such an examination. Only individuals whose functions are considered key must pass the examinations, namely:

- sellers in charge of informing or advising the provider's clients about transactions involving financial instruments such as the purchase of units in venture capital funds (FCPRs), etc.
- managers authorized to make investment decisions under either an individual management mandate or in managing one or several funds;
- the internal control compliance officer (RCCI). Note that the RCCI must have an RCCI professional card.

Aside from these key functions, a service provider may decide to apply this system to other individuals, regardless of their functions.

- Application in time

This obligation to test the knowledge of employees does not apply to people already employed as of July 1, 2010. That is, people exercising key functions on July 1, 2010 in the company benefit from a "grandfather clause". If they change companies after July 1, 2010, however, they will be subject to professional testing and the grandfather clause no longer applies.

This means that any person who is hired after July 1, 2010 must submit to a test of his or her knowledge within six months after taking up any of the above listed functions. Any person who fails the examination will not be allowed to exercise the key functions for which he has been hired!

The AMF's annual report

As each year in June, the *Autorité des Marchés Financiers* (or French Market Authority) presented its annual report. In 2009, it received 37 applications for the approval of new management companies. This was less than in either 2007 or 2008, when respectively 49 and 52 management companies requested approval.

The report confirmed the determination of professionals to diversify. A growing number of already existing management companies requested to diversify their service offerings. This trend is likely to continue in the future as the UCITS IV directive is transposed to French law (see the above editorial).

Regarding private equity funds, the AMF noted a steep falling off in the number of vehicles: in 2009, it received declarations for 44 FCPRs benefiting from a simplified procedure. This represented a 77% reduction from the number of declarations in 2008! Only one contractual FCPR was declared by December 31, 2009.

On the other hand, the AMF's issuance department saw a very sharp increase in the number of issuances outside regulated markets relative to 2008 (48 visas compared with 18), mainly ISF (holding company type) wealth-tax products.

Questions & Answers about advice as defined by the directive MiFID directive

The Committee of European Securities Regulators (CESR) published a document aimed at clarifying the notion of investment advice. It is defined as supplying a personalized recommendation to a person as either an investor or potential investor. But since 2007 this definition has constantly raised questions.

This document's added value lies in the distinction it makes between investment advice, a regulated investment service theoretically reserved for investment service providers[3], and corporate finance advice, a related, non-regulated service.

It adds a reminder that "*advice given to a company to issue securities does not constitute investment advice",* and that *"corporate finance advice is supplied when the advice in question is given as regards capital structure, industrial strategy and related matters*".

In addition, "*as regards private equity or venture capital companies, the industrial objective of any companies providing services is purely financial. When persons authorized to act on behalf of this type of companies request advice, their main objective is entrepreneurial in nature, in keeping with the industrial aim of all private equity or venture capital companies, i.e. to generate yield. When these clients request advice in this context, the CESR considers that this is corporate finance advice*."

As a result, all players regardless of their status (whether management companies, SCRs or companies governed by French commercial law), and regardless of any approval they may have (whether for investment advice or not), are authorized to provide this type of advice.

Tax News

Wealth tax: 2010 collection – Publication of a decree regarding reporting requirements – Publication of instructions defining wealth tax exemptions – Draft decree on costs

- 2010 collection

The overall intermediate collection is due to amount to €565m, breaking down as follows:

- €180m from holding companies,
- €285m from funds (in particular FCPRs)
- €100m through management and advice mandates.

- Postponement of reporting requirements for the reduction in wealth tax as per Article 885-0 V bis of the French Tax Code (CGI).

Articles 299 septies and 299 octies of appendix III of the CGI (French Tax Code) required individual statements of account to certify subscription (direct, in a holding company or a fund) to be included with income tax returns. But since all income tax returns must be filed by 15 June latest each year[4], these requirements were incompatible with the time

[3] Which, however, may be offered by financial investment service providers.

[4] Specific periods of time are set forth for non residents.

needed to market and invest in vehicles with wealth-tax reductions. For this reason, the tax authorities decided that individual statements could be sent in on 15 September instead of 15 June.

In order to place this tolerance on a lasting basis, the government modified the French tax code to allow three additional months (usually until 15 September) for taxpayers to produce their supporting documents.

- Wealth-tax exemption as per Article 885-I ter of the general French Tax Code: publication of tax instructions

Shares in holding companies and units in funds with the right to wealth-tax reductions are also totally or partially exempted from wealth tax.

Shares in a wealth-tax holding company are exempted "*up to the fraction of their gross assets' real value as representing the value of securities received in return for its subscription to initial capital of or to capital increases made by eligible companies*". As for units in funds, "*the exemption is limited to the fraction of the value of units in these funds as representing securities received in return for subscription to the capital of eligible companies*".

The tax instruction dated June 7, 2010 (BOI 7 S-5-10) sets forth this measure's practicalities. It calls for units in wealth-tax funds to be valued at NAV as at January 1 each year and to be exempt in proportion to the percentage of the investment as stated in the fund rules.

In addition, to benefit from this exemption, taxpayers, companies and fund managers are strictly held to reporting requirements. To date, the details of these requirements had dealt only with direct investments (Article 299 bis of Appendix 3 of the French Tax Code).

The new tax instruction has plugged this gap by defining the reporting requirements for holding companies and funds. They differ when the tax exemption is requested for the first time or for following years.

As an example, a taxpayer who subscribed to the capital of a wealth-tax holding company in May 2009 and benefits from a reduction in his 2009 wealth tax will benefit from the exemption starting with his 2010 wealth tax. He has until September 15, 2010 to send in a certificate from the holding company. But in the following years, he must attach a new certificate to his tax returns by June 15 each year.

- Holding companies' and wealth-tax funds' marketing costs: a decree dealing with these costs should be published shortly

The decree should improve investors' information about the amounts of marketing costs.

This information will no longer be mentioned only in the information notice but will have to appear in all documentation: the by-laws, the commercial brochure and the subscription form.

In addition, the amount of information given will be improved. It will no longer be possible merely to mention a maximum amount of marketing costs. The real percentage of costs paid to marketers throughout the fund's life must also be given in detail, whether they are paid directly as entry fees or indirectly through the retrocession of management commissions.

The Inspectorate's report is postponed to the end of September

Christine Lagarde has mandated the French General Finance Inspectorate (IGF) to study the usefulness of tax incentives aimed at prompting individuals to invest in SMEs (through income tax or wealth tax reductions).

Its report is due to be published in late September, just before the 2011 Finance Bill is reviewed. It is expected to seal the fate of such tax shelters as FCPIs and FIPs, due to expire at the end of the current year. However, a stage report should be issued at the end of July allowing the drafting of the 2010 Finance Bill.

Value-added contribution: mutual funds are not liable!

The Finance Law for 2010 did away with the professional tax and its minimum contribution, replacing these by an "economic territorial" contribution made up of:

- a company real-estate contribution, and
- a company value-added contribution (CVAE)[5].

These new taxes are due in particular from companies whose main activity is the management of financial instruments as per Article L. 211-1 of the Monetary and Financial Code. These companies are defined as those which meet at least one of the two following conditions:

- financial fixed assets such as marketable securities held by the company represented on average at least 75% of its assets during the period mentioned in Article 1586 quinquies;
- sales from the management of financial instruments corresponding to investment income and income from the sale of securities during the period mentioned in Article 1586 quinquies were higher than total sales from other businesses.

Even though they are engaged in this business, mutual funds are expressly exempted from this contribution. Christine Lagarde has just granted the request of the AFG (*Association Francaise de Gestion Financière*) in a letter stating that "mutual funds (SICAVs) do not exercise this professional activity" and "do not come within the field of application of the economic territorial contribution (CET), in particular the value-added contribution (CVAE)". One can only regret that a comparable provision has not been obtained for the SCR.

The tax authorities are issuing a draft law on fiscal transparency for partnerships for consultation

The current French tax treatment of "sociétés de personnes" - partnerships - is a system referred to as being "translucent" which means that partnerships are subject to tax but can make profits for tax without being liable for the tax due on those profits. Instead, in accordance with article 8 of the French General Tax Code, the partners in such firms are liable to personal income tax or corporate income tax for their share of the profits arising from their rights in the partnership.

This therefore makes it a system different to that of transparency in which partners would be deemed to own the assets and profits of the firm directly (as is the case for example

[5] Article 1447-0 of the French Tax Code

with co-ownership property companies covered by article 1655 3 of the General Code) and from “opaqueness”, in which the company is liable for tax on its own name, and in which the shareholders are liable for tax only on the increase in their net wealth when the company pays remuneration (as is the case with entities liable to corporate income tax).

This system can produce both tax friction and tax advantages that are sometimes unintended. That is why the tax authorities want to reform the current treatment. They have no intention of putting a system of pure transparency in place. Its complexity in terms of monitoring filing of returns and its inconsistency with legal and accounting rules bar its general application. However, it is expected to move a considerable distance from the current translucent treatment toward pure transparency.

It is unfortunate that no approach be made in order for contractual FCPRs to benefit from this tax treatment, which would level them with other types of European funds; their current tax treatment not being truly favourable.

In Brief

Advantages: Report on good and bad practices

The CESR, mentioned above, also published a report on the advantages in terms of the MiFID. The CESR analyzed the monetary advantages received by third parties aimed at improving the quality of services rendered.

The AMF updates its doctrine regarding UCITS

The AMF has updated the following three documents:
- Guide to drawing up a prospectus for a UCITS
- Summary findings from an examination of the behaviour of UCITS
- Guide to good practice in drawing up commercial documents.

The marketing of FCPRs: do you observe the AMF’s latest regulation?

On June 15, 2009, the AMF published instructions nos. 2009-05 and 2009-06 regarding prospectuses for approved FCPRs and simplified-procedure FCPRs. These instructions require new information to be mentioned in the fund’s by-laws (and the information notice of approved FCPRs). All funds in existence on the date when these instructions were published, i.e. June 15, 2009 and whose marketing period was still open one year later, must alter their prospectuses to comply with these instructions.

A bill presented by Senator Adnot

Senator Adnot presented a bill aimed at changing the income tax reduction system for investments in SMEs under the following conditions:

- the so-called "Madelin" reduction for direct investment in an SME may give the right to a reduction in income tax up to a maximum amount of €50,000 for unmarried individuals and €100,000 for married couples, provided the investment is made in companies in business for less than five years, with a workforce of less than 50 and sales or a balance sheet total of less than €10m. However, certain businesses are ruled out, e.g. tourist and rental residences, etc.).

- the reduction in income tax for investing into a holding company applies only if the holding company’s exclusive business is to hold interests in companies which fulfill the above conditions.

- the reduction in income tax for subscribing to units in FCPIs is also reserved for those FCPIs which invest in such companies.

- no proposed reforms exist regarding the reduction in income tax for subscribing to units in FIPs, however.

This proposal has not yet been recorded in the Senate's agenda.

Upcoming conferences

- September 15 to 17, 2010 – **Capital Creation Conference** – Le Méridien Beach Plaza Hotel, Monaco. Speakers: Robin Painter, a partner from the Boston office and Robert Barry, a partner from the London office. Proskauer is this conference's main sponsor.

- September 21, 2010 – ***Les Rendez-vous Lamy de l'Actualité,*** the Lamy news discussion on the following themes: **Psychosocial risks: stress, moral harassment and suicide: how to prevent them and the employer's liability**. Speaker: Yasmine Tarasewicz, a Proskauer partner. Intercontinental Hotel Paris, from 9 a.m. to 5 p.m.

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Corporate and Private Equity

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