KIRKLAND & ELLIS

Kirkland Alert

EU and UK Regulatory Update for Fund Managers

19 July 2021

In this *Alert*, we summarise the key regulatory developments of importance to sponsors in four main areas, each of which will impact how sponsors operate or raise capital in Europe.

Key Takeaways

- Considerations for Fundraising in Europe
  - EU AIFMs must review their marketing strategies and consider the impact of the highlighted regulatory developments to pre-marketing timelines, reverse solicitation practices and use of intermediaries to market funds to professional investors in Europe.
  - Monitor implementation of the new directive and regulation on cross-border distribution of collective investment undertakings in EU member states for extension to non-EU AIFMs.
  - There may be changes to key areas of the AIFMD regime such as delegation, and managers should monitor developments in this area.

- Sustainability
  - SFDR requires additional disclosures but there has been a delay to the implementation of the more onerous "Level 2" obligations. Many areas of SFDR remain unclear and managers should continue to monitor for further regulatory clarification in this area.
  - Taxonomy Regulation comes into force on 1 January 2022, and will supplement the disclosures under SFDR.
  - UK managers and advisers should review the TCFD recommendations and

prepare for the implementation of proposed FCA rules extending the TCFD disclosures to asset managers. At the same time, the TCFD itself is evolving, and managers should monitor the changes to the TCFD framework.

  - Managers should monitor the EU's revised sustainable finance strategy for important updates such as the extension of the EU taxonomy framework to transitional activities and additional sustainable activities, for minimum sustainability criteria for Article 8 funds, for clarification of the principal adverse impacts related to social and employee matters, respect for human rights, anti-corruption and anti-bribery matters, and for a report on social taxonomy.

- Prudential Regulation
  - IFPR will likely impact all functions across a firm's business, and firms should get their preparations under way. Firms should establish their categorisation and review their own funds to determine to what extent, the firm's capital adequacy requirements will increase.

- Themes for Regulatory Focus in 2021/2022
  - Firms should prepare for the FCA to move towards a more outcomes-based supervisory model. This will offer some flexibility to firms to adopt an approach that would best suit their structure, operating models and employees.
  - The FCA's proposed new rules on SPACs provide many similarities to a US-listed SPAC. Market participants are eager to see whether the proposed changes will be sufficient to encourage investors to back larger UK-listed SPACs.
  - A further anti-avoidance directive adds to the existing pressures of using intermediate holding companies and blockers in investment and fund structures. Structures should be reviewed to ensure appropriate levels of substance and (where not already implemented) consider adopting a single holding company jurisdiction in which to focus.

Considerations for Fundraising in Europe

A. Cross-Border Directive on Marketing of Funds

The EU's new regulatory package on the cross-border marketing of funds will

impact how sponsors fund raise in Europe.

Who is in scope?

All EU Alternative Investment Fund Managers ("AIFMs") managing and marketing an Alternative Investment Fund ("AIF"). Non-EU AIFMs should also consider these proposals as, while there is some uncertainty, there is likely to be some impact on them.

What is changing?

The new rules aim to harmonise the meaning of "pre-marketing" and introduce other important changes, such as:

- the obligation to make an informal notification to the local home state regulator within two weeks of conducting any pre-marketing;
- a restriction on relying on reverse solicitation for 18 months after pre-marketing. Any subscription made within 18 months of pre-marketing activity will be considered the result of active marketing, requiring compliance with AIFMD marketing passport requirements;
- where a third-party intermediary is used to pre-market in the EU, a requirement that the intermediary be an EU-authorised entity; and
- conditions for de-notification of passporting arrangements and a restriction on marketing the relevant fund or another fund with a similar investment strategy or idea for 36 months after de-notification.

The new rules have been discussed in detail in our earlier *Alert*.

Impact on non-EU AIFMs: The new rules apply only to EU AIFMs. However, at the time of writing, some EU member states have signalled that they will also apply the new rules to non-EU AIFMs.

The rules will also be particularly relevant to UK AIFMs that previously benefited from a MIFID passport in order to market funds to EU investors. As a consequence of Brexit and with no equivalence framework in place, such UK firms will be treated as non-EU AIFMs.

What is next?

The package of reforms is set to apply from 2 August 2021, although some EU member States are adopting their own timelines.

B. AIFMD Review

One of the key regulatory considerations for sponsors fundraising in Europe is how the European Commission will revise the Alternative Investment Fund Managers Directive ("AIFMD") pursuant to its ambitious and detailed public consultation, which closed in January 2021.

Who is in scope?
Any EU AIFM or non-EU AIFM that manages an AIF in the EU or markets an AIF to EU investors.

What is changing?

- **ESMA key topics:** The consultation follows ESMA's letter to the European Commission on the review of AIFMD. ESMA recommended some priority topics (including delegation, leverage and reporting requirements) for the European Commission to consider.
- **Scrutiny on host AIFM models:** Specifically, ESMA has flagged delegation models and the use of third-party AIFM structures as requiring more scrutiny, particularly in the context of Brexit. ESMA notes that such AIFMs rely on delegation of portfolio management functions, which are often delegated to entities outside of the EU, where AIFMD rules do not apply.
- **Delegation:** ESMA recommends that further legal clarifications on the maximum extent of delegation would be helpful to ensure supervisory convergence and that sufficient substance is maintained in the EU. ESMA further recommends subjecting the delegate to regulatory standards under AIFMD, irrespective of the delegate's regulatory license or location. Such additional compliance requirements would represent a potentially significantly change in current operating models for many sponsors who rely on the delegation model.

What is next?

On the one hand, many industry bodies have advised against a complete overhaul of AIFMD especially in light of the market disruption due to COVID-19. On the other hand, ESMA has over the last 18 months advocated for more regulation in asset

management, and less member state discretion. It remains to be seen how the European Commission will reconcile the different responses to the AIFMD consultation.

Feedback from the European Commission is expected in the third quarter of 2021.

Sustainability

For managers, the focus on integration of environmental, social and governance ("ESG") factors at both the portfolio level and the individual investment level continues to gain traction across all markets. This trend is bolstered by new ESG-focussed rules that impact asset managers in the EU and in the UK.

A. Sustainable Finance Disclosure Regulation ("SFDR")

Who is in scope?

SFDR applies to EU managers and non-EU managers who market funds in the EU.

What is changing?

SFDR requires EU managers, and non-EU managers who market funds in the EU, to make basic disclosures on how sustainability risks are integrated into their investment decision-making processes, and whether they consider the principal adverse impacts of their investment decisions on sustainability factors. SFDR came into force on 10 March 2021.

Funds that promote environmental and/or social characteristics, and funds with sustainable investments as their investment objective are required to make further (and detailed) disclosures regarding the specific characteristic or investment objective promoted, and what indicators will be used to monitor progress against such characteristics or objectives.

What is next?

Further "Level 2" disclosure obligations were poised to come into force on 1 January 2022, however, the implementation date has been delayed by the

European Commission to 1 July 2022 with the aim of introducing certain additional obligations and facilitating a smoother implementation.

There are still many areas of SFDR that remain unclear, and further guidance from the European Commission has been sought on various key aspects. As noted in our earlier *Alert* on this subject, managers should continue to monitor for further regulatory clarification in this area.

B. Taxonomy Regulation

Who is in scope?

The Taxonomy Regulation applies to EU managers and non-EU managers who market certain funds in the EU.

What is changing?

The Taxonomy Regulation supplements the disclosures under SFDR. The Taxonomy Regulation introduces a framework to determine whether, and to what extent, an economic activity qualifies as “environmentally sustainable”. The Taxonomy Regulation’s two “climate change objectives” become effective on 1 January 2022, with the remaining four “environmental objectives” taking effect on 1 January 2023.

An “environmentally sustainable economic activity” must:

- contribute substantially to one or more of the following objectives: (i) climate change mitigation; (ii) climate change adaptation; (iii) sustainable use and protection of water and marine resources; (iv) transition to a circular economy; (v) pollution prevention and control; and (vi) protection and restoration of biodiversity and ecosystems;
- not significantly harm any of the other environmental objectives;
- be carried out in compliance with the minimum safeguards set out in the Taxonomy Regulation (including the OECD Guidelines for Multinational Enterprises, the International Labour Organisation, etc.); and
- comply with the technical screening criteria developed by the Technical Expert Group in the form of delegated acts.

What’s next?

Managers should note that pre-contractual and periodic disclosures on the aspects described above are required from 1 January 2022. In addition, managers will be required to disclose the minimum taxonomy alignment of a fund's investments.

C. TCFD and FCA Consultation on Extending TCFD Recommendations to UK Managers

The Task Force on Climate-related Financial Disclosures ("TCFD") framework for assessing and reporting on climate-related risks and opportunities continues to gain traction globally, with regulators, managers, and other market participants broadly supporting its use. The latest example is a Communiqué issued on 13 June 2021, in which the G7 leaders expressed support for mandatory disclosures based on the TCFD framework.

In the UK on 22 June 2021, the FCA published draft rules on expanding the TCFD disclosure requirements to a wider section of financial market participants. Final rules are expected later this year.

Who is in scope?

The rules are expected to apply to FCA-authorised full scope AIFMs, sub-threshold AIFMs, FCA UCITS management companies, discretionary investment managers and "portfolio managers", which include entities providing ongoing investment advice to institutional clients. The FCA explicitly aims to bring into scope asset management activities conducted by private equity and other private market firms.

Managers with less than £5 billion assets under management/assets administered are excluded from scope. This exemption will capture nearly all sub-threshold AIFMs.

What is changing?

The draft rules require disclosures at two levels: entity (or firm) level and portfolio (or fund) level.

- **Entity-level disclosure requirements**
  Governance, Strategy and Risk Management: Firms will need to produce a TCFD entity report annually, in line with the "principles" of the TCFD disclosure requirements. Broadly, this will involve firms disclosing their respective approaches to the governance of climate-related risks and opportunities, as well

as how those risks and opportunities are factored into the firm's strategy and risk management. The report must include a "compliance statement" signed by a member of senior management, confirming that the disclosures comply with the requirements set out in the FCA rules.

Scenario Analysis: Firms will also be required to disclose their approach to climate-related scenario analysis. Scenario analysis involves qualitatively or quantitatively assessing how a business will be affected by physical risk and transition risk (i.e., policy, legal, technological, and market risk) under different climate trajectories. The FCA acknowledges that tools and capabilities in this area are still evolving, and approaches are likely to diverge across firms, investment strategies and asset classes.

Metrics/Targets: Consistent with the TCFD's recommendations, where a firm has set a climate-related target, the firm must describe the target, including the key performance indicators it uses to measure progress, in its TCFD entity report.

Delegation: If a fund manager delegates investment management to a third-party portfolio manager that is not in the same group, that authorised fund manager will remain responsible for producing a TCFD entity report that sets out its approach to the TCFD's recommendations, including a signed compliance statement.

- **Product/portfolio-level disclosures**
  The product or portfolio-level disclosures also need to be produced annually, and should be included in client communications or made available to investors on request.

  Governance/Strategy/Risk Management: Product or portfolio-level disclosures would only need to include information on governance, strategy, and risk management if they were materially different from the approach taken at the entity level.

  Scenario analysis: Scenario analysis (as described above) would be required at portfolio level as well. The FCA requires, at minimum, a qualitative, "top down" scenario analysis.

Core and additional metrics: The disclosures require reporting on a core set of metrics, which include Scope 1 and 2 GHG emissions and Scope 3 GHG emissions.

Assumptions/Proxies: Firms are required to address data gaps using assumptions and proxies. Firms must identify where they have done so and briefly explain the methodologies used, in addition to any contextual information and limitations of the approach.

What's next?

The rules are expected to come into effect in phases:

- in the first phase effective from 1 January 2022, the rules come into force for the largest, most interconnected managers, i.e., managers with assets under management/asset administered of more than £50 billion (calculated as a three-year rolling average).
- in the second phase effective from 1 January 2023, the rules come into force for all managers with assets under management/assets administered of more than £5 billion (calculated as a three-year rolling average).

TCFD Consultation

At the same time as these rules are coming into force, the TCFD is itself evolving. In October 2020, the TCFD launched a consultation on forward-looking metrics that should be disclosed by financial institutions, such as the implied temperature rise ("ITR") associated with an investment portfolio. That consultation closed in March 2021 and, on 7 June 2021, the TCFD launched a one-month consultation on two draft documents:

1. Proposed Guidance on Climate-related Metrics, Targets, and Transition Plans: This guidance would update current TCFD guidance on metrics and targets in a number of key ways, including recommending that managers:

- "describe significant concentrations of exposure to carbon-related assets";
- "measure and disclose the alignment of their portfolios consistent with a 2°C or lower temperature pathway (e.g., Paris-aligned), and incorporate forward-looking alignment metrics into their target-setting frameworks and management processes"; and
- "disclose the appropriate financed-emissions metric, based on [the Partnership

for Carbon Accounting Financials'] methodology and [weighted-average carbon intensity], if relevant, or a comparable methodology, for their industry where data is available or can be reasonably estimated".

The consultation would also update TCFD guidance around disclosure of climate transition plans.

2. **Measuring Portfolio Alignment: Technical Supplement:** This supplement describes strategies for aligning investment portfolios with the goals of the Paris Agreement, including ITR as well as other methodologies and metrics.

What's next?

TCFD is expected to finalise the proposed updates in Q3 2021 after the close of the consultation. Managers in the UK should closely monitor the TCFD updates and consider how they would apply them in light of the on-going FCA consultation on TCFD disclosures.

D. EU's Strategy for Financing the Transition to a Sustainable Economy

On 6 July 2021, the European Commission published its renewed Strategy for Financing the Transition to a Sustainable Economy (the "Strategy"). The Strategy has four areas of focus:

- Financing the transition of the real economy towards sustainability: increased focus on recognising transition activities.
- Inclusiveness: increased access to sustainable finance opportunities for individuals and small- and medium-sized enterprises ("SMEs").
- Financial sector resilience and contribution: how the financial sector can contribute to the European Green Deal targets, become more resilient and combat greenwashing.
- Global ambition: fostering of international consensus on sustainable finance.

Who is in scope?

The proposed strategy is relevant to EU managers and non-EU managers who access EU markets.

What is changing?

The key points from the Strategy of relevance to asset managers include:

- extending the EU taxonomy framework to transitional activities and additional sustainable activities;
- adopting technical screening criteria for the remaining four objectives under the Taxonomy Regulation so as to facilitate environmentally sustainable investments beyond climate-related criteria;
- developing minimum sustainability criteria for Article 8 funds under SFDR (i.e., funds that promote environmental or social characteristics);
reviewing the "Level 2" measures under SFDR to clarify principal adverse impacts related to social and employee matters, respect for human rights, anti-corruption and anti-bribery matters;
- publishing a report on social taxonomy; and
- assessing supervisory powers to address greenwashing.

In addition, the Commission will explore how the Shareholder Rights Directive II may better reflect the EU's sustainability goals and align with guidelines for global best practices in stewardship.

What is next?

The Commission has committed to reporting on implementation of the Strategy by the end of 2023.

Prudential Regulation

The UK Investment Firm Prudential Regime ("IFPR") introduces a new prudential regime for MiFID investment firms regulated by the FCA, based heavily on the EU Investment Firm Regulation and Directive (IFR/IFD). The FCA has published two of three consultation papers setting out its proposals, and a policy statement based on the feedback in relation to the first consultation paper. The rules published thus far address some key areas that impact UK-based investment firms, including collective portfolio management investment firms and adviser/arranger firms.

Who is in scope?

The extent to which investment firms are impacted by IFPR will depend on the firm's size and operational set up, "interconnectedness" and the underlying risk of activities carried out. In this respect, an important step for firms in preparing for IFPR is to establish their category. Categorisation impacts the amount of capital to be held by the investment firm and the types of remuneration obligations that will apply to it (see below).

The FCA has proposed two categories of investments firms:

1. Small and non-interconnected ("SNI") firms: firms that meet all of the following conditions (together, the "SNI Thresholds"):

- average assets under management ("AUM") is less than £1.2 billion;
- average client orders handled ("COH") for:
  - cash trades is less than £100 million per day; and
  - derivative trades is less than £1 billion per day;

- average assets safeguarded and administered is zero;
- average client money held is zero;
- on- and off-balance sheet total is less than £100 million; and
- total annual gross revenue from investment services and activities is less than £30 million.

These SNI Thresholds, with the exception of the on- and off-balance sheet totals only relate to the MIFID activities that the firm undertakes.

2. Non-SNI firms: firms that exceed any of the SNI Thresholds listed above.

What is changing?

1. Capital and own funds

Non-SNI firms have a capital requirement corresponding to the higher of:

- their fixed overheads requirement ("FOR"): at least 25% of the fixed costs of the preceding year;
- their permanent minimum capital requirement ("PMR"): likely to be £75,000 for most firms; or
- the K-factor requirement: consisting broadly of individual quantitative indicators

intended to represent the risks that a firm can pose to clients, to the market and to the firm itself.

SNI firms have a capital requirement corresponding to the higher of:

- their FOR: at least 25% of the fixed costs of the preceding year; and
- their PMR: £75,000

K-factors are individual quantitative indicators intended to represent the risks that a firm can pose to clients, to the market and to the firm itself. Of importance to managers is the K-factor related to assets under management (AUM), which includes:

- assets managed on a discretionary portfolio management basis; and
- assets managed under non-discretionary advisory arrangements of an ongoing nature.

The draft rules define 'assets managed under non-discretionary advisory arrangements of an ongoing nature' as "the recurring provision of investment advice as well as the continuous or periodic assessment and monitoring or review of a client portfolio of financial instruments, including of the investments undertaken by the client on the basis of a contractual arrangement".

There is some uncertainty as to how average AUM based on non-discretionary advisory arrangements must be calculated, particularly in relation to private equity advisory arrangements. Industry bodies have responded to the FCA's consultation paper seeking clarification on this.

2. Liquidity

The draft proposals in IFPR introduce a requirement for all FCA investment firms to meet a liquid assets requirement, and set out the asset types that can be used to meet this requirement. FCA investment firms are required to hold liquid assets equating to at least 30% of their FOR (and 1.6% of any guarantees provided to clients).

3. Internal Capital and Risk Assessment ("ICARA") process

The FCA draft rules provide for systems and controls through which firms will need

to monitor their risk management and governance responsibilities. Broadly, this includes:

- identifying and monitoring harms: includes processes on assessing harms;
- risk mitigation: consider financial and non-financial measures to mitigate risk;
- capital/liquidity planning and stress testing: includes the requirements to make forward looking assessments;
- recovery planning: identify early warning indicators to avoid capital/liquidity difficulties; and
- wind-down planning and triggers: incorporate measures to ensure orderly wind down.

Where the mitigation of risks has not been sufficient, investment firms are required to hold sufficient own funds and liquid assets to ensure they can address potential material harms from its ongoing business and wind down its business in an orderly way (the Overall Financial Adequacy Rules, or OFAR).

4. Remuneration requirements

The FCA has proposed that the existing IFPRU and BIPRU remuneration codes will be consolidated into a new combined remuneration code — the MIFID remuneration code, which comprises three tiers of requirements depending on the size and categorisation of the investment firms.

“Basic” remuneration requirements will apply to all FCA investment firms, including SNI firms. This is an area of divergence from the IFR/IFD, which only requires non-SNI firms to comply with the remuneration rules. SNI firms will need to have a remuneration policy in line with the firm’s business strategy and objectives, and be subject to oversight and periodic review by the management body of the firm. All remuneration must be categorised as either fixed or variable, and the firm must set an appropriate balance between them. In addition, the remuneration structure must not affect the firm’s ability to ensure a sound capital base.

“Standard” remuneration requirements apply to non-SNI firms. In addition to the basic remuneration requirements, non-SNI firms will be required to apply additional requirements in respect of “Material Risk Takers” (MRTs). These additional requirements include the requirement to:

- set a maximum ratio between fixed and variable remuneration;

- ensure that performance related variable remuneration of MRTs is based on the performance of the individual, and the relevant business of the unit and firm;
- ensure that all current and future risks are considered when measuring performance to calculate bonus pools and when awarding/allocating bonuses; and
- determine triggers and minimum periods for malus and clawback to cover situations where the MRT was responsible for conduct resulting in significant losses or where the MRT fails to meet appropriate standards of fitness and propriety.

"Extended" remuneration requirements apply to the largest non-SNI firms, i.e., firms with:

- total on- and off-balance sheet assets over a four-year period of more than £300 million (on a solo basis); or
- total on and off-balance sheet assets over a four-year period of more than £100 million (but less than £300 million), and trading book business of over £150 million, and/or derivatives business of more than £100 million.

In addition to 'basic' and 'standard' remuneration requirements, firms subject to extended remuneration requirements are required to:

- put in place a remuneration committee;
- defer at least 40% of the variable remuneration (or 60% where the variable remuneration exceeds £500,000) for at least three years;
- pay out 50% of the variable remuneration in shares, other instruments or alternative arrangements (approved by the FCA); and
- ensure variable remuneration is subject to an appropriate retention policy.

Carried interest arrangements are expected to be treated as remuneration under IFPR, whilst co-investments are not. As it stands, the remuneration rules on adjustments, malus and clawback described above also are expected to apply in relation to carried interest. Industry bodies have written to the FCA to emphasise that carried interest should be treated as inherently meeting the objectives of the pay-out/deferral process rules without needing to be subject to further requirements on deferral and pay-out in instruments.

What is next?

The IFPR is expected to come into effect on 1 January 2022. IFPR will likely impact all functions across a firm's business, and firms should get their preparations under way. Firms should identify their categorisation and review their own funds to determine to what extent, the firm's capital adequacy requirements will increase. Although there are some transitional provisions relating to the new capital requirements, no transition period is available for the remainder of the rules (such as the risk framework under ICARA, which will be new to many exempt CAD firms).

Themes for Regulatory Focus in 2021/2022

A. FCA Focus on Culture and Non-Financial Misconduct

Who is in scope?

All FCA-authorised firms.

What is changing?

Over the last year, the FCA has, through speeches at industry events and Dear CEO letters, emphasised a key message to market participants in the financial services industry: culture matters. Marc Teasdale, the FCA Director of Wholesale Supervision, recently noted that the FCA has identified the following four drivers of culture:

- leadership: the tone from the top and how that cascades through the firm;
- people policies: how behaviours are incentivised and disincentivised in the firm, extending to remuneration, progression, promotion, diversity and inclusion;
- governance: how decisions are made; and
- corporate purpose: the fundamental driver of culture.

This emphasis has cascaded to enforcement action on non-financial misconduct whether in the workplace or outside of it. The FCA's priority on transforming culture and embedding behavioral change is expected to continue.

What is next?

Firms should prepare for the FCA to move towards a more outcome-based supervisory model. This will offer some flexibility to firms to adopt an approach that would best suit their structure, operating models and employees.

B. SPACs in the UK

The US has seen unprecedented levels of capital raised by special purpose acquisition companies ("SPACs"). There was comparatively little activity in Europe during 2020 and even less so in relation to the UK.

2021 has seen a step change with a number of issuers raising European focused SPACs on Euronext Amsterdam (e.g., Odyssey Acquisition SA raising €300 million), Frankfurt (e.g., Lakestar SPAC 1 SE raising €275 million) and Paris, with several more expected over the coming months. Many of these SPACs have, in broad terms, replicated structures used in US-listed SPACs so as to remain appealing to investors.

In the UK, while there were a number of high profile listings of SPACs in 2016 and 2017, the regulatory environment, and in particular the UK's listing rules, has meant that offering investors structures which are analogous to the US SPACs has been a challenge. A particular issue has been that there is a presumption that when the UK-listed SPAC announces a proposed acquisition, its shares will be suspended from trading under the reverse takeover rules. This presumption is meant to ensure that a disorderly market is avoided as a result of incomplete information about an acquisition being available at the time of its announcement (or leak). However, the suspension denies investors the liquidity that they would enjoy in US-listed SPACs.

It is not clear that this regulatory hurdle has caused a relative lack of UK-listed SPACs, but empirical evidence would suggest that there has been a relative dearth of large UK-listed SPACs (the FCA estimated in April there were 33 UK-listed SPACs with only two having a capitalisation in excess of £100 million, with two-thirds having a value of £5 million or less).

What is changing?

This is set to change in the coming months as the FCA has announced (in April 2021) a consultation and proposed changes to the Listing Rules. Pursuant to the proposed changes, the presumption of a suspension of listing will not apply if:

- the SPAC has raised at least $200 million, excluding any funds from the SPAC sponsors;
- the proceeds from public shareholders are ring-fenced via an independent third party and are only used to fund: an acquisition approved by the board and public shareholders, redemption of shares from public shareholders or repayment of capital to public shareholders (if no acquisition can be found);
- the SPAC must be time-limited (e.g., it must complete an acquisition within two years of listing, subject to a one year extension if an acquisition has been announced but not yet completed);
- where there is conflict of interest between the target group and a SPAC director, the board must include a statement that the proposed transaction is fair and reasonable. However, the FCA is consulting as to whether this should be a requirement for all SPACs;
- the acquisition must be subject to approval by the Board and a majority of the public shareholders; and
- the SPAC must provide an option for the public shareholders to be redeemed before any proposed acquisition completes and must set out details of this option in the prospectus of the SPAC.

The above changes would result in a structure that provides many similarities to a US-listed SPAC.

What is next?

The consultation has now closed and so conclusions and definitive rules are anticipated shortly. Market participants are eager to see whether the above changes are sufficient to encourage investors to back larger UK-listed SPACs.

C. A Further EU Anti-Tax Avoidance Directive - Tackling Shell Companies – (“ATAD 3”)

Economic substance is now a key requirement in international structures, specifically for the application of double tax treaties, EU tax directives and to prevent the application of national anti-abuse measures. The issue has also been considered by the European Court in the so-called Danish cases, along with several actions at OECD and EU levels to tackle the use of abusive tax structures and aggressive tax planning. Despite this, as part of its “business tax agenda for the 21st century” (published in May 2021), the EU plans to introduce additional measures targeting the misuse of shell entities, as it considers that these entities

continue to pose a significant risk of being used in aggressive tax planning. The EU Commission is currently consulting on the proposal and aims to adopt measures in the first quarter of 2022 in the form of a further anti-avoidance directive ("ATAD 3").

Who is in scope?

Legal entities and legal structures in the EU.

What is ATAD 3 looking to achieve?

The Commission is looking to neutralise the misuse of shell entities created for the main purpose of reducing the tax liability or disguising improper conduct of the group or operations of which they are a part. Shell companies in this context are legal entities and arrangements with no or minimal substantial presence and real economic activity. Whilst the use of shell entities for tax abuse purposes, and other issues such as money-laundering, is an obvious target, the use of entities for certain activities (such as holding companies dealing with passive income) are specifically singled out by the Commission.

What is changing?

The key proposals include:

- requiring companies to provide the tax authorities with the necessary information to assess whether they have a substantial presence and real economic activity;
- denying tax benefits linked to the existence or the use of abusive shell companies; and
- creating new tax information, monitoring, reporting, and tax transparency requirements.

No guidance has yet been provided on what may constitute sufficient substantial presence and/or whether it would vary relative to the purpose of the entity in question. The Commission does, however, appear to recognise that there may be valid (legal or economic) reasons for the use of such entities in the countries in which they are incorporated.

What is next?

The proposal reflects the likely direction of travel. Sponsors are already moving

away from using holding companies to either local country regulated and listed structures and/or using LP/investor tax characteristics to do direct deals. If adopted, the measures will add to the existing pressures of using intermediate holding companies and blockers in investment and fund structures. When further details emerge and where such companies are used, structures should be reviewed to ensure appropriate levels of substance, and (where not already implemented) consider adopting a single holding company jurisdiction in which to focus.

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