

Cross-border distribution of collective investment funds within Europe

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On 12 March, the European Commission published a Proposal with respect to Cross-Border Distribution of Collective Investment Funds. This is interesting on two counts. First, it illustrates the EU's persistence in thinking that increased regulation is a way of freeing up cross border marketing. Secondly, with regard to the UK's post Brexit position, it may, in part, inform how distribution models of UK managers promoting funds in the EU may be reformulated.

Context

The March Proposal comes under the banner of the package of measures which comprise the Capital Markets Union initiative. There are two component parts to the proposal:

- One for a Regulation facilitating cross-border distribution of collective investment funds and amending the EuVECA and EuSEF Regulations, and
- A draft Directive amending the UCITS Directive and AIFMD.

One can complain that various EU developments in the funds area have not been fully thought through. Notably AIFMD was a rushed Directive with political motivation – so some of its text was not carefully considered. This March Proposal does though seem to have been carefully considered. Alongside the draft Regulation and Directive, a detailed Commission Staff Working Document is issued by way of an Impact Assessment.

Also it is part of the wider CMU initiative and so should be considered part of the Commission's carefully considered preferred approach to further prescribing matters and now an increasing interest in running matters centrally – increasing the relevance of ESMA, and potentially at the expense of the powers of local regulators in individual EU Member States.

Drivers for new approach

We have been discussing the inefficiencies of cross border activity for a long number of years. Indeed a major feature of UCITS IV was to try and improve the notification process and encourage efficient use of passports. The fact that this initiative is being pursued is indicative of the impression that the cross border promotion of funds is still not working seamlessly.

Statistics which the European Commission highlight are that 70% of total assets under management held by investment funds are registered for sale only in their domestic market place (including what they call "round trip funds", where a manager domiciles a fund in another Member State and then distributes it back only in the market in which they are based). Only 37% of UCITS and about 3% of AIFs are registered for sale to more than three Member States.

Also that there seem to be a huge number of EU funds, with EU funds being significantly smaller than, say, the typical fund size for a US fund: this is perceived as potentially having a negative impact on economies of scales, fees paid by investors etc.

The expressed objective of the European Commission in issuing the proposal is as follows:

"This proposal is expected to reduce the cost of going cross-border and should support a more integrated single market for investment funds. Increased competition in the EU will help to give investors more choice and better value."

But is this new approach justified? Certainly for AIFs it is arguable that a better EU wide NPPR regime would be preferable.

We need to bear in mind the impression when AIFMD was being negotiated that there was a move against private placements with the idea of switching off the national private placement regimes (NPPR) once the AIFMD third country passporting regime were switched on. Whilst it seems increasingly unlikely, that the rather elderly discussion back in 2007/8 for an EU wide national private placement regime, that might be a preferable approach, certainly for AIFs for professional investors. Third country funds with third country managers are quite happily using the individual national private placement regimes at the moment and would probably prefer to see a more co-ordinated EU wide national private placement regime being developed. It might well be that funds and fund managers operating within the EU would welcome an easy and straightforward EU wide national private placement system.

What is proposed?

This though is not the route which the EU is choosing to pursue. It remains focussed on making the passporting regime work.

The Commission has chosen to issue proposals for a Directive amending the UCITS and AIFMD Directives which would need to be implemented in each Member State. (The intention is that the provisions under this new Directive will be transposed by Member States within 24 months after it enters into force.). Alongside these is to be a directly applicable Regulation amending various provisions.

The particular areas of focus concern:

- transparency
- fixing the pre marketing issue
- regulatory fees
- local facilities and
- notification requirements.

In the following paragraphs we set out the three key areas of the proposals: first of all amending the UCITS Directive; secondly for amending AIFMD; and thirdly the contents of the new Regulation.

UCITS Directive amendments

• Marketing communications

The current marketing communications provision in Article 77 is to be deleted. Instead there will be enhanced requirements of marketing communications in the directly applicable Regulation on facilitation of cross border distribution of funds.

Article 2 of that new Regulation is to set out various requirements for marketing communications including the following:

- AIFMs or UCITS management companies must ensure that all marketing communications to investors should be identifiable as such; present risks and rewards of purchasing units or shares of an AIF or of a UCITS in an equally prominent manner and that all information included in marketing communications is fair, clear and not misleading.
- UCITS ManCos must ensure that no marketing communication contradicts information or diminishes the significance of information contained in its prospectus and key investor information documents. All marketing communications must indicate that a prospectus exists and that the KIID is available. They must also indicate how, and in which language, investors can obtain the Prospectus and KIID.
- AIFMs must ensure that no marketing communication comprises an invitation to invest in the AIF that contains specific information about the AIF, makes any statement that contradicts information to be disclosed in accordance with Article 23 of AIFMD or diminishes its significance. Likewise this will apply in respect of AIFs which publish a prospectus or apply rules on the format and content of the KIID referred to in Article 78 of the UCITS Directive.
- ESMA is to issue guidelines and then update these periodically on the application of these requirements, taking into account online aspects of marketing communications.

Whilst this is essentially based on Article 77 of the UCITS Directive, by expanding it and putting it into a directly applicable Regulation with related ESMA Guidelines, it is rather centralising matters and probably increasing expectations.

• Publication of marketing requirements

Also to be deleted is Article 91(3) of the UCITS Directive which requires complete information of local marketing requirements to be made accessible from a distance and

by electronic means, and in a language customary of the sphere of international finance. Instead, and again, there will be requirements under the new Regulation.

Article 3 of the new Regulation is to require publication of national provisions concerning marketing requirements:

- Each competent authority must publish and maintain on their website central databases containing all relevant provisions, governing marketing requirements for AIFs and UCITS and also notify ESMA of these.
- ESMA is to develop implementing technical standards to determine standard forms, templates and procedures for notifications
- ESMA is going to be obliged to make a report on the marketing requirements information provided and update this every two years. under this Regulation.

Under Article 4, ESMA will also maintain a central data base on national provisions which will be available on its own Website.

Again, the centralisation theme is clear.

• Local facilities

Regarding local facilities, Article 92 of the UCITS Directive is to be amended. Replacing four simple lines, it is proposed to have one page of replacement text. The intention is to ban any imposition by individual Member States of a physical local presence. There will though be a requirement to have facilities in each Member State where marketing activities are carried out which meet the relevant purpose of servicing dealings in units.

• Notification procedures

Article 17 and 93 are to be amended regarding the notification procedures. To give an indication of how specific this proposal might make it, a new Article 93(a) is intended to allow asset managers to de-notify the marketing of a UCITS only if a maximum of ten investors who hold up to 1% of assets under management of the UCITS are invested in it in a particular Member State.

AIFMD amendments

For AIFMD, the proposals include the following:

• Pre-marketing

Premarketing has always been a tricky issue, not least because of the different scope of the financial promotion regimes which apply in each Member State – with the UK probably being the widest in its scope.

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There is to be a new Article 30(a) proposed for AIFMD which sets out conditions for premarketing in the Union by an EU AIFM: the intention is to allow premarketing without notifying the competent authorities of the premarketing activities. But one wonders if it is sophisticated enough. It seems to assume that there is a not yet established AIF whereas in various fundraising propositions there will actually be a vehicle established, just not launched. Surely it would be better to have a provision which allows premarketing provided that, at a later stage, there is compliance with the full marketing requirements prior to any subscription being possible.

(Specific Articles on EuVECA and EuSEFs will introduce the concept of pre marketing for these vehicles to the relevant regulations for those respective vehicles.)

- **Discontinuation of marketing**

A new Article 32(a) is proposed to deal with discontinuation of marketing of EU AIFs in other Member States.

- **Local facilities**

A new Article 43(a) is introduced so that local facilities are made available to retail investors should they be offered shares in an AIF – the provision matching those explained above in relation to UCITS.

Additional points in the new Regulation

Expanding upon the provisions in the directly applicable Regulation – in addition to the terms already mentioned for marketing communications and new transparency framework above:

- **Verification of marketing communications by regulators**

National regulators may require systematic notification of marketing communications which UCITS Management Companies intend to use (although it will not be a pre-condition for marketing UCITS). Where AIFMs can market to retail investors units or shares in their AIFs this will similarly apply to AIFMs.

Where this information is collected, there then needs to be an annual report to ESMA on decisions taken in the preceding year rejecting or requesting adaptations to marketing communications.

One would not anticipate national regulators being too keen on undertaking the detailed verification. Marketing communications are somewhat different from formally required documentation to do with the constitution of an

entity or the formal prospectus. It would seem inappropriate to give regulators this role and, from the Manager's perspective, it seems to be interfering with their own commercial business of marketing their products.

- **Regulators' fees and charges**

The proposals fall short of specifics on fees. Instead they simply indicate that fees or charges levied by a relevant authority should be proportionate to the expenditure relating to the authorisation or registration or the performance of the relevant powers under either the UCITS Directive or AIFMD.

Matters might be constrained by peer pressure. A new Article 7 of the Regulation will require publication of national provisions concerning fees and charges on the various regulators' websites. Competent authorities must notify ESMA of the levels of fees or charges and, where applicable, the calculation methodologies for those fees or charges. Any change must also be notified to ESMA. Given that ESMA can develop draft regulatory technical standards to specify the information to be notified, one suspects they could develop standards which would be quite specific and require evidence of proportionality.

ESMA is then to be entrusted under Article 8 with maintaining an interactive database on fees and charges which can include the calculation methodologies used. In addition, that database is supposed to provide for interactive tools on fees and charges that allow the user to perform online calculations – which are publicly accessible.

- **ESMA's central database**

As further evidence of centralisation, ESMA is asked to run a central database on AIFMs, UCITS Management Companies, AIFs and UCITS, as well as the Member States in which those funds are marketed. (Article 10 refers.)

- **Sending notifications to ESMA**

Another aspect of the centralisation drive is that, under Article 11, relevant regulators will be required to transmit notifications and notification letters referred to in Article 10 to ESMA. It seems to be anticipated that ESMA will be implementing Technical Standards to specify the forms, templates and procedures under the various relevant Articles of the UCITS Directive and AIFMD, including the procedure for transmission of the information by the relevant authorities to ESMA.

The intention is that the Regulation is, as mentioned above, directly applicable and that it will be evaluated five years after it comes into force.

Likely impact?

The most important aspect of this Proposal is perhaps as an indication of the direction of travel in the way regulation is developing.

Consider:

- **Does more regulation inevitably make better regulation?**

The perhaps erroneous assumption behind the Proposal is that introducing further specific regulation will actually make the marketing passports work better.

- **Other more important issues inhibit cross border distribution?**

Whilst one can see that some of these specific proposals deal with some of the distinctions between national states, they perhaps do so in too prescriptive a way. Also, as admitted in the Impact Assessment document, there are various out of scope problem issues concerning taxation, market structure and, dare it be said, investor behaviour! Also, distribution methods vary hugely and it is really in these distribution methods that perhaps the greatest revolution, or perhaps a fast evolution, is happening.

- **Is greater harmonisation through centralisation of regulation a good thing?**

A key feature to note in the Impact Assessment is the reference to "*The EU's right to act on justification*".

Feedback from Consultations indicates that national implementation of UCITS and AIFMD has resulted in differing interpretations applicable to the use of marketing passports, and they see the problem as relating directly to the application of European and national legislation and supervisory practices for Member States. So it is thought necessary that uniformity and legal certainty regarding the use of the passport can be best ensured by taking action at EU level. It is noted that "*previous efforts to converge national (supervisory) practices in this area through ESMA have not succeeded to address the identified problem.*"

Centralisation elements are very much a feature in these and likely other new proposals, as a means of achieving harmonisation.

The main issue and the main recurring theme, as you will see from the above summary, is centralisation of some of the regulatory powers or at least potential for exercise of power by ESMA. If followed through in this and other areas, this would be a remarkable and important development within European fund regulation.

And just one final cheery thought:

Reviews of AIFMD and UCITS Directive are underway. It is commented in the Impact Assessment that this cross-border marketing initiative is being pursued now on a standalone basis prior to the overall reviews of AIFMD and the UCITS Directive because, for both reviews, there is not enough evidence to be able to decide currently whether any further legislative changes would be merited. The Commission's overall review of AIFMD has just started. An overall review of the UCITS Directive may take place once enough experience is gained with the practical application of elements introduced with the most recent amendments to the Directive. Whilst we had hoped that the UCITS VI proposals, which have, in the main, been addressed individually, had gone away. This reference to overall review for both of the Directives for funds heralds the prospect of further specific initiatives - and potentially further centralisation?

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