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# *European Fund Regulatory Developments - What's on the Horizon?*

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# Agenda

- Where are we and what's on the horizon?
- EU lawmaking – post Lisbon Treaty changes
  - who does what and do I need to read that?
  - growing maximum harmonisation
  - growing product intervention powers (supporting disclosure/conduct rules)
- Fortress Europe (delegation/third country rules)/Fortress USA – barriers to entry
- Distribution issues
  - Sophisticated UCITS
  - Inducements changes
- UCITS IV and V
  - How is UCITS IV implementation going?
  - Governance
  - Depositaries

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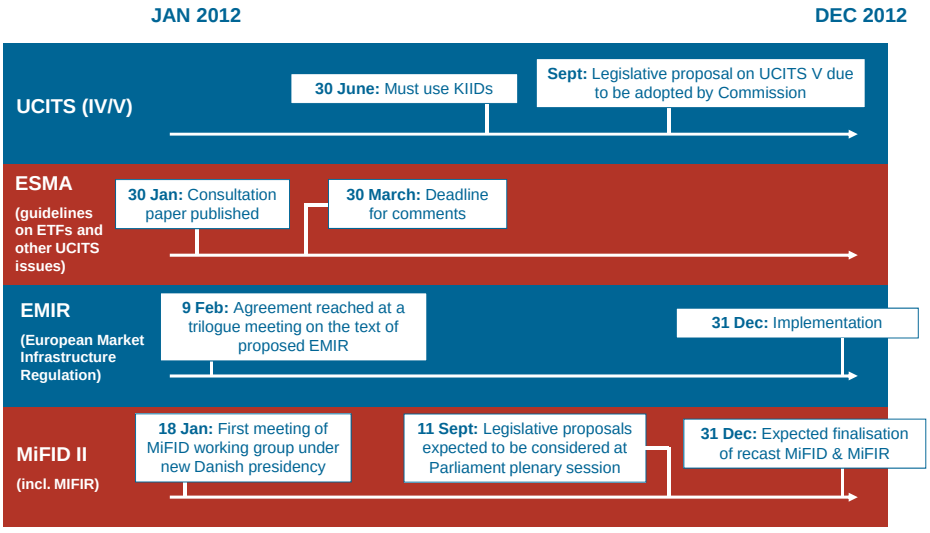
# Where are we and what's on the horizon?

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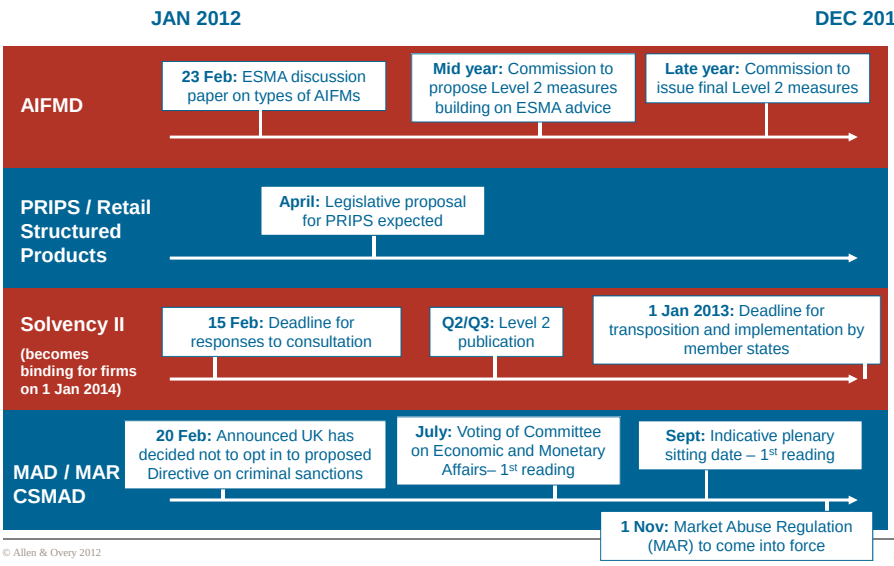
# Where are we and what's on the horizon?

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# Where are we and what's on the horizon?

- UK retail distribution review – into force 31 Dec 2012
- Financial transaction tax debate
- Reform of data protection rules (25 Jan 2012 proposal)
- Venture Capital Funds/Social Entrepreneurship Funds
- Building on G20
  - Shadow banking consultations – Commission led conference in April
  - Financial Conglomerates Directive review – Commission work programme
- US changes that impact on EU funds/fund management arms – Dodd Frank/Volcker/CFTC/SIFIs/FATCA

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## Lawmaking process – Who does what (or whose report should I focus on)?

- New lawmaking process for subordinated acts (post Lisbon Treaty)
- Recap on interaction between Commission, ESMA (and other ESAs), Parliament (and rapporteur), Council and other entities
- Role of ESMA (and other ESAs) – replacing Lamfalussy Level 3 committees
  - Help develop a single rule-book (drafting advice and technical standard laws). Mediating (and settling) disputes between national regulators. Ability to give binding decisions in certain circumstances. Intervention powers. CRA supervision. Monitoring systemic risk. International arrangements.
- New types of subordinated acts with different procedures
  - Traditional Level 2 process still applied for non-technical standards
  - Binding technical standards (whether a delegated "regulated technical standard" or an "implementing technical standard") can be developed by ESMA (and other ESAs) (still needs Commission endorsement)

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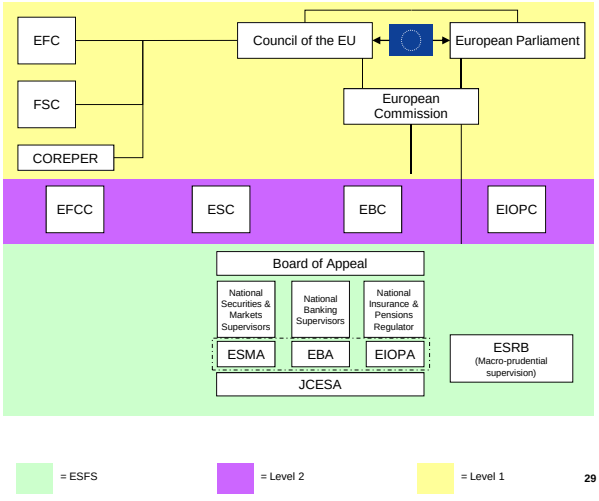
## Quick EU overview

Key

| | |
|---|---|
| EFC: | Economic and Financial Committee |
| FSC: | Financial Services Committee |
| COREPER: | Committee of Permanent Representatives |
| EFCC: | European Financial Conglomerates Committee |
| ESC: | European Securities Committee |
| EBC: | European Banking Committee |
| EIOPC: | European Insurance and Occupational Pensions Committee |
| ESMA: | European Securities and Markets Authority |
| EBA: | European Banking Authority |
| EIOPA: | European Insurance and Occupational Pensions Authority |
| ESRB: | European Systemic Risk Board |
| JCESA: | Joint Committee of European Supervisory Authorities |
| ESFS: | European System of Financial Supervision |

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## New financial services technical standards process

Level 1 Directive or Regulation (specifies the type and process for subordinated acts)

| "Delegated act" to "amend or supplement" Article 290 TFEU | | "Implementing act" to "ensure uniform conditions of application" Article 291 TFEU | |
|---|---|---|---|
| Simple delegated act | Regulatory technical standard (RTS) | Simple implementing act | Implementing technical standard (ITS) |
| • 'Traditional' Level 2<br>•Conditions set out in Directive<br>• Similar to pre-Lisbon regulatory procedure with scrutiny (RPWS)<br>• Scrutiny by EP & Council who can object or revoke the delegation<br>• Directive or Regulation | • Conditions set out in ESA Regulations<br>• Scope defined by Level 1<br>• Endorsement by Commission<br>• Power delegated for 4 yrs<br>• Scrutiny by EP and Council who can object or revoke the delegation<br>• Regulation<br>• Level 2 or 3? | • "Traditional" Level 2<br>• Scrutiny by MS committees through comitology<br>• New "examination" procedure likely to apply (set out in new Comitology Regulation)<br>• Directive or Regulation | • Endorsement by Commission<br>• Powers conferred indefinitely<br>• Comitology does not apply (exceptionally)<br>• No other Member State, EP or Council scrutiny<br>• Regulation<br>• Level 2 or 3? |

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Source: FSA



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## Towards a single rule-book

- De Larosière concerns of financial supervision in Europe:
  - Supervision remains at national level and uncoordinated
  - Inconsistency in application of rules across single market
  - Need new supervisory framework for financial regulation
- Such concerns resulting in binding technical standards methodology and increased use of Regulations (directly effective) rather than Directives
- Could lead to potential advantage in greater harmonisation of rules but less flexibility in regulatory approach adopted in member states
- Examples:
  - MiFID II proposals including a Regulation (MIFIR) and Directive (MiFID II)
  - EMIR
  - MAD II proposals to include a Regulation on insider dealing and market manipulation (MAR) and Directive on criminal sanctions for such market abuse (CSMAD)
  - KIID UCITS regulation
  - Binding Technical Standards as Regulations

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# Growth of product intervention powers

– ESMA powers
  – **Investor alerts/consumer warnings**
  – **Temporary bans (if products or activities threaten financial stability or the orderly functioning of financial markets) – limited to 3 months – risk of repeated bans?**
– MiFID II proposals include:
  – **National regulators having powers to permanently ban products in co-ordination with ESMA**
  – **Position limits - powers for regulators to require existing product positions for commodity derivatives and to require emissions allowances to be reduced**
  - **Links with both MiFID II and MAD II which are updated to include instruments traded on multilateral trading facilities and organised trading facilities as well as trading of emission allowances**
- Powers of UK's Financial Conduct Authority ("FCA" part successor to FSA)
  - **more intensive supervision of product governance and strengthening of FCA ability for enforcement action**
  - **intervention powers in Financial Services Bill – if expedient to meet its consumer protection objective or its competition objective – block launch/prohibit existing product – must cease within 12 months**

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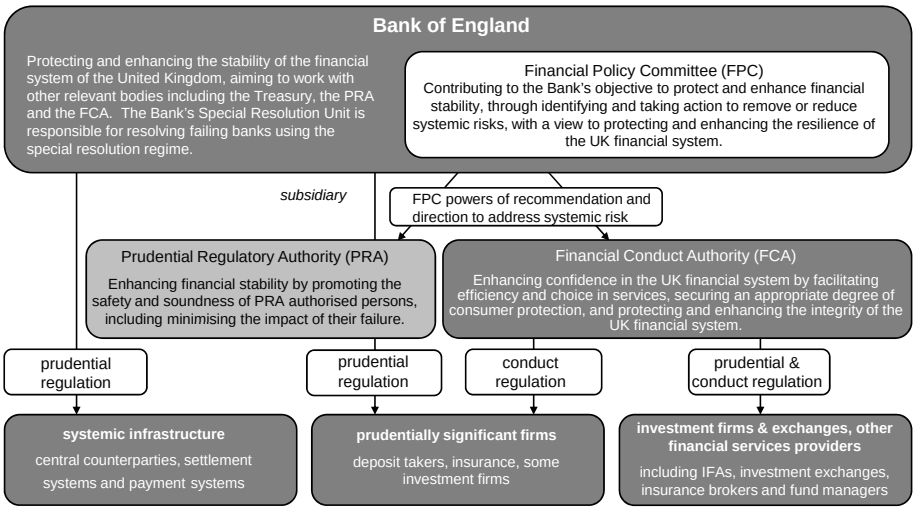
# Future UK Regulatory Structure

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## Fortress Europe? - Barriers to entry for US fund businesses

– The issue…

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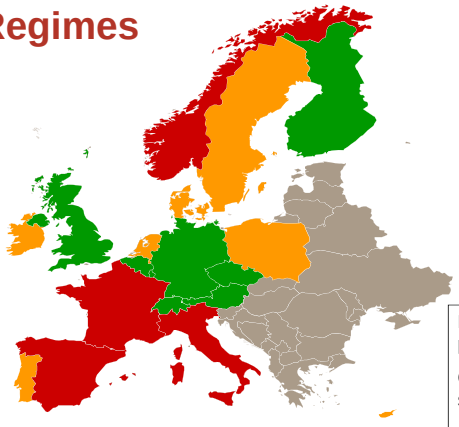
## Example – Variations in current EU Private Placement Regimes



Red – limited ability to privately place

Orange – some ability subject to rules

Green – can privately place though NB there are still rules

Inevitably a generalisation!

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## Fortress Europe? - Barriers to entry for US fund businesses

- One world - How to access EU investors?
  - UCITS/AIFMD/MiFID
  - distribution passports – can I use them?

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## Fortress Europe? - Marketing and Distribution Activities – who can do what

| | MiFID Firm | UCITS ManCo | AIFM |
|---|---|---|---|
| Marketing of UCITS | Yes, subject to RTO/investment advice licenses | Yes | Yes, but potential need for RTO/investment advice licenses for UCITS managed by third parties |
| Marketing of AIFs | Yes, subject to RTO/investment advice licenses | Yes, as falling with its marketing function | Yes |
| Global Distributor (i.e. appointing distributors) | Yes | Yes | Yes |

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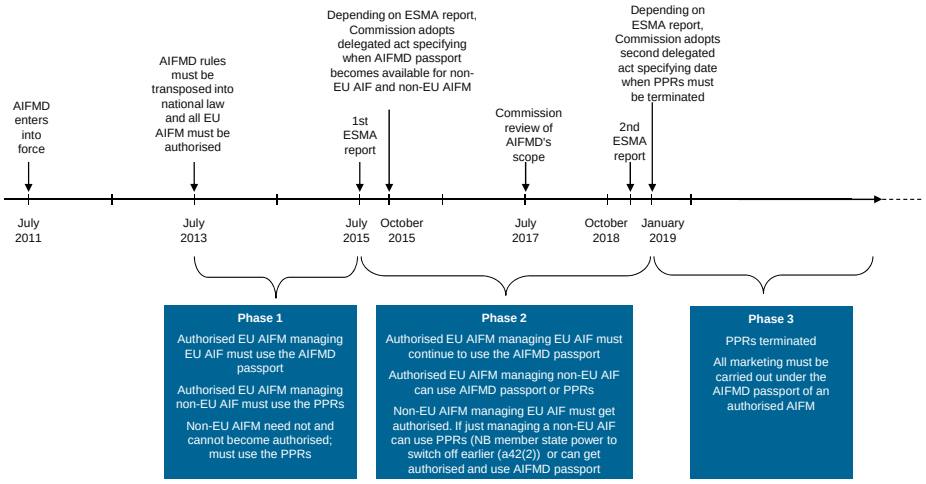
# Fortress Europe? - AIFMD – Timing and Choices

**Phased Implementation – AIFMD Timeline**

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# Fortress Europe? - Barriers to entry for US fund businesses

- One team - how to use non-EU based colleagues?
  - Providing services to EU funds/fund managers
    - delegation rules
      - From EU member state
      - From non-EU member state
    - compare
      - UCITS
      - AIFMD (cooperation agreements/equivalence)
      - MiFID (and MiFID II)

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## Fortress Europe? - Barriers to entry for US fund businesses

- One team - how to use non-EU based colleagues?
  - Third country rules
    - AIFMD (a34-42) – cooperation agreements – ESMA Level 2 advice (note retail is left to national regulators)
    - MiFID II (a41-50)
      - new approach – assessing equivalence
      - new branch requirements for retail
    - UCITS third country rules – update to reflect MiFID II?
  - what about overseas persons exemptions/reverse enquiry?

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## Delegation

| | MiFID Firm | UCITS ManCo | AIFM |
|---|---|---|---|
| Delegation of management functions | **Yes, if specific conditions are complied with, in particular, the delegate must (art13(5)/L2 art 13-15):**<br>**-have the ability, capacity and relevant authorisations to perform reliably and professionally**<br>**-cooperate with MiFID Firm's supervisory authorities**<br>**-properly supervise the carrying out of outsourced functions and manages related risks**<br>**-protect confidential information** | **Yes, if specific conditions are complied with (art13):**<br>**-approval of the delegate by the supervisory authority of the UCITS ManCo**<br>**-licensing of the delegate in its home country**<br>**-disclosure to investors/ no conflicts of interests**<br>**-UCITS ManCo shall not become a letter box** | **Yes, if specific conditions are complied with (similar to UCITS) (art 20 – L2):**<br>**-justification of the entire delegation structure (NB sub-delegation too)**<br>**-the delegate must have sufficient resources and be of sufficiently good repute and sufficiently experienced**<br>**-the delegate is qualified and capable and is selected with due care**<br>**-licensing of the delegate in its home country or otherwise no objection from the AIFM supervisory authority**<br>**-disclosure to investors/no conflicts of interests**<br>**-AIFM shall not become a letter box** |
| Liability of the delegating entity | **The MiFID Firm remains fully responsible for discharging its legal obligations and the relationship and obligations towards the client must not be altered** | **The liability of the UCITS ManCo is not affected by delegation of any functions to third parties** | **The liability of the AIFM is not affected by delegation of any functions to third parties, or by any further sub-delegation** |

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# Delegation

| | MiFID Firm | UCITS ManCo | AIFM |
|---|---|---|---|
| Additional conditions for delegation to a non-EU entity | -Cooperation between the supervisory authorities concerned must be ensured<br>-the delegate must be authorised or registered in its home country<br>→ Possible derogation of conditions if the supervisory authority of the MiFID Firm does not object (L2 art 15) NB MiFIDII | Cooperation between the supervisory authorities concerned must be ensured (usually not an issue for US delegates) | Cooperation between the supervisory authorities concerned must be ensured (probably not an issue for US delegates) |
| Monitoring obligations | -the MiFID Firm must supervise the outsourced functions effectively and manage associated risks<br>- MiFID Firm must be able to terminate the delegation where necessary<br>-delegate to give effective access to data on outsourced activities to the MiFID Firm, its auditors and competent authorities | The UCITS ManCo must be in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors | -the AIFM must be in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors<br>-the AIFM shall review the services provided by each delegate on an ongoing basis |

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# Portfolio Management Activities – who can do what

| | MiFID Firm | UCITS ManCo | AIFM |
|---|---|---|---|
| Establishing/Managing UCITS | No | Yes | Yes, subject to the additional UCITS ManCo license |
| Self-managed UCITS | Can be appointed as delegated porfolio manager unless in some EU Member States | Can be appointed as delegated investment manager | Can be appointed as delegated portfolio manager |
| Establishing/Managing AIF | No | Yes, subject to the additional AIFM license | Yes |
| Manager to a Self-managed AIF | Can be appointed as delegated portfolio manager | Can be appointed as delegated investment manager | Can be appointed as delegated portfolio manager |
| Delegated investment manager of an UCITS | Yes, unless in some EU Member States | Yes | Yes, subject to the additional UCITS ManCo license |
| Delegated investment manager for an AIF | Yes | Yes, subject to the proper program of operations | Yes |

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## Depositary and Valuation Agent Activities – who can do what

| | MiFID Firm | Credit Institutions | UCITS ManCo | AIFM |
|---|---|---|---|---|
| A UCITS depositary | Yes | Yes | No | No |
| Sub-custodian of an UCITS depositary | Yes | Yes | No | No |
| An AIF depositary | Yes | Yes | No | No |
| Sub-custodian of an AIF depositary | Yes | Yes | No | No |
| Prime broker of an AIF | Yes, subject to functional independence | Yes, if licensed as an investment services provider | No | No |
| Valuation agent for an AIF/UCITS | Yes, unless if it is the UCITS depositary in some EU countries | Yes, unless if it is the UCITS depositary in some EU countries | Yes, subject to functional independence | Yes, subject to functional independence |

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## Fortress USA? - Barriers to entry for EU fund businesses

- Access to US investors / Access to US services for non-US investors
  - registration/exemptions/compliance with:
    - Dodd Frank Act including
      - investment adviser registration requirements
      - Volcker rule
    - broker dealer rules
    - investment company act
    - pay to play rules – state level
  - CFTC commodity pool changes
  - SIFIs
  - FATCA

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# Distribution Developments – Sophisticated UCITS

- Growth of sophisticated UCITS
- BIS/FSB April 2011 concerns with (systemic) liquidity risks for synthetic ETFs
- ESMA discussion paper (July 22, 2011) on UCITS ETFs and structured UCITS
- ESMA proposals for guidelines (Jan 30, 2012) – wider scope – all ETFs and UCITS
  - Index tracking (leveraged) ETFs
  - ETFs – identifier/active management
  - Efficient portfolio management (stock lending/repos)
  - TRS/strategy indices
  - Out of scope – selling prohibitions on "unnecessarily complex" products and splitting of complex/non-complex products
- Commission view on splitting UCITS category – not in UCITS V, waiting for response to ESMA guidelines

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# Distribution Developments – Inducements

- MiFID II – complex UCITS and new inducements rules
  - UCITS currently deemed non-complex – proposal that structured UCITS (defined in KII regulation) become complex
    - ease of clearly identifying the two categories?
    - results in an appropriateness test
    - Trojan horse?
  - new inducements rules will remove some incentives to advisers pushing more complex/higher commission paying products – growth of simpler cheaper products?
    - investment advice
      - is it on an independent basis – no third party inducements/diverse assessment of products
      - it is on a broad or more restricted analysis of the market
    - portfolio management – no third party inducements
- Differences with UK's RDR
- UCITS IV – similar inducements rule to MiFID I for investment management and administration – i.e. not distribution (article 29 of UCITS organisation directive)

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# UCITS IV

- UCITS IV – practical review of experience on new passporting regime
  - new UCITS ManCo passport does not seem to have caught on yet, but too early to tell
    - opportunity to rationalise EU management structures
    - opportunity to rationalise EU business structure in conjunction with getting AIFM licence
  - new UCITS passporting rules (regulator to regulator procedure) have improved the efficiency of the UCITS passport but
    - technical challenges remain (problems with format/transmission)
    - UCITS to host state regulator procedure applicable in certain cases - limits the efficiency of the procedure
  - procedure for marketing authorisations is a success - shorter marketing timelines for UCITS managers

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# UCITS IV

- UCITS IV – practical review of experience on KIIDs
  - Significant production work undertaken
  - Becoming more routine
  - Still some concerns with local disclosure standards and need for some content from simplified prospectus to go into main prospectus
- UCITS IV – practical review of experience on mergers and master/feeders
  - new procedures in place to increase structural efficiency
  - difficult to assess the impact because
    - the new merger procedure is applicable to both domestic and cross-border mergers – more cumbersome domestic merger procedures than before
    - no tax harmonisation for cross-border mergers so tax uncertainties not lifted in many cases
    - Lack of data available

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# UCITS IV

– UCITS IV – new governance rules for UCITS ManCo (mostly MiFID)
  – new requirements on internal procedures, organisation and resources
  – obligation to put in place appropriate complaints handling, electronic data processing and accounting procedures
  – obligation to set up permanent compliance, internal audit and risk management functions – functional independence subject to derogations
  – new regime applicable to personal transactions, recording and recordkeeping obligations as well as conflicts of interests and strategies for exercise of voting rights

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# UCITS IV

– UCITS IV – new rules of conduct for UCITS ManCo (mostly MiFID)
  – duty to act in the best interests of UCITS and their unitholders and to carry out due diligence on UCITS investments (non-MiFID obligations)
  – reporting obligation on investor trading activity (subscription/redemptions)
  – best execution
  – rules on order handling, including aggregation and allocation of trading orders
  – inducements

➢ Senior management is responsible for ensuring compliance with the new organisational and conduct of business rules and their ongoing implementation and review

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# UCITS V

- Remuneration
  - comparison with AIFMD
  - impact on US teams?
- Depositaries
  - comparison with AIFMD

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# UCITS V

- Comparing the current UCITS depositary regime with UCITS V and AIFMD (1)

| | UCITS III/IV | AIFMD | UCITS V |
|---|---|---|---|
| Depositary's duties | -duty of safe-keeping: general principle, no detailed regime<br>-oversight functions which differ if the UCITS is a corporate or contractual vehicle<br>-delegation: no specific provision<br>-depositary contract: no provision except where UCITS ManCo is located in another EU Member State | -duty of safe-keeping: detailed regime applicable where assets are held in custody by the depositary<br>-monitoring duty: detailed regime applicable for other assets<br>-oversight functions: same as current UCITS for contractual vehicles, but applicable to all types of AIF<br>-delegation: possible only for safe-keeping duty and under specific conditions<br>-depositary contract: content specified by the AIFMD | -duty of safe-keeping: same as AIFMD except for RE and commodities<br>-monitoring duty: same as AIFMD<br>-oversight functions: same as AIFMD (but to be further implemented)<br>-delegation: same as AIFMD to a certain extent (no delegation possible to non-compliant delegates). Also, additional information to investors on sub-custodian networks<br>-depositary contract: same as AIFMD |

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# UCITS V

– Comparing the current UCITS depositary regime with UCITS V and AIFMD (2)

| | UCITS III/IV | AIFMD | UCITS V |
|---|---|---|---|
| Depositary's liability regime | -liability standard: no provision<br>-liability for losses by third parties: the liability of the depositary is not affected by the fact that safe-keeping has been entrusted to a third party<br>-burden of proof: no provision<br>-direct claims of investors: only for investors in corporate vehicles | -liability standard: the depositary is liable for its negligence or intentional failure<br>-liability for losses by third parties: same as current UCITS, but details - liability of the depositary except force majeure or specific exceptions<br>-burden of proof: the depositary carries the burden of proof<br>-direct claims of investors: available for all investors | -liability standard: same as AIFMD<br>-liability for losses by third parties: same as AIFMD but specific exceptions not applicable<br>-burden of proof: same as AIFMD<br>-direct claims of investors: same as AIFMD, but to be further detailed |
| Eligibility criteria | eligible entities: List of criteria, but no exhaustive list of eligible entities | eligible entities: Exhaustive list of eligible entities | -eligible entities: same as AIFMD<br>-possibility of a provision on commitment to assess and re-examine the need to address depositary passport issues |

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# UCITS V

– Comparing the current UCITS depositary regime with UCITS V and AIFMD (3)

| | UCITS III/IV | AIFMD | UCITS V |
|---|---|---|---|
| Supervision issues | -no provision on scope of competencies of national supervisors<br>-no provision on external audit of third party delegates of the depositary<br>-no provision on appointment of a single depositary<br>-no rules of conduct<br>-obligation of disclosure to the competent authorities: only if necessary to supervise compliance with UCITS Directive | -no provision on scope of competencies of national supervisors<br>-external audit of third party delegates of the depositary to ensure that the assets are in its possession<br>-appointment of a single depositary: mandatory<br>-specific rules of conduct<br>-obligation of disclosure to the competent authorities: any information obtained by the depositary while carrying out its duties | -scope of competencies of national supervisors to be harmonised<br>-external audit of third party delegate of the depositary: same as AIFMD<br>-appointment of a single depositary: same as AIFMD<br>-specific rules of conduct: same as AIFMD, but additional implementing measures contemplated<br>-obligation of disclosure to the competent authorities: same as AIFMD, but additional implementing measures contemplated |

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## Conclusions

- Massive quantity of relevant and important paper to read and continuing growth of level 2/3 documentation
- Interaction between the different regimes - similar concepts across AIFMD/UCITS/MiFID – not always same terminology/result
  - conduct of business/governance
  - addition of product intervention to point of sale controls and disclosure
  - changing landscape from the inducements changes
- Outsourcing – concerns over equivalence

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## Questions?

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