The Asset Management Review

Sixth Edition

Editor
Paul Dickson

The Law Reviews

THE ASSET MANAGEMENT REVIEW

The Asset Management Review
Reproduced with permission from Law Business Research Ltd.

This article was first published in The Asset Management Review, - Edition 6
(published in Spetember 2017 – editor Paul Dickson)

For further information please email
Nick.Barette@thelawreviews.co.uk

The Asset Management Review

Sixth Edition

Editor
Paul Dickson

The Law Reviews

PUBLISHER
Gideon Roberton

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGERS
Thomas Lee, Joel Woods

ACCOUNT MANAGERS
Pere Aspinall, Sophie Emberson,
Laura Lynas, Jack Bagnall

PRODUCT MARKETING EXECUTIVE
Rebecca Mogridge

RESEARCHER
Arthur Hunter

EDITORIAL COORDINATOR
Gavin Jordan

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Tessa Brummitt

SUBEDITOR
Janina Godowska

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-910813-82-9

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ADVOKATFIRMAET BA-HR DA

ALLEN & OVERY LLP

APPLEBY

ARTHUR COX

BONELLIEREDE

CYRIL AMARCHAND MANGALDAS

DE PARDIEU BROCAS MAFFEI

FANGDA PARTNERS

HENGELER MUELLER

HENRY DAVIS YORK

KING & SPALDING LLP

LENZ & STAEHELIN

LIEDEKERKE WOLTERS WAELBROECK KIRKPATRICK

MAPLES AND CALDER

MORI HAMADA & MATSUMOTO

PINHEIRO NETO ADVOGADOS

ROPES & GRAY LLP

SLAUGHTER AND MAY

STIKEMAN ELLIOTT LLP

UDO UDOMA & BELO-OSAGIE

URÍA MENÉNDEZ

WMWP RECHTSANWÄLTE

CONTENTS

Chapter 1

EUROPEAN OVERVIEW

Nick Bonsall[1]

I INTRODUCTION

As part of the focus in the EU in the past few decades on strengthening the single market in the provision of financial services, increasing numbers of asset management activities in European Economic Area (EEA) Member States[2] have been brought within the regulatory perimeter at European level. This trend looks likely to continue, at least in the short to medium term, as evidenced by a growing number of EU legislative proposals that are either directly aimed at the investment funds industry or that will nonetheless catch investment funds, investment managers or depositaries within their scope. It remains uncertain how the UK's decision to leave the EU will affect any future EU legislative proposals.

Traditionally, much of the EU's legislative activity in financial services has been in the form of directives, which – unlike regulations – are not directly applicable within Member States and do not have national legal effect (except in limited specific circumstances) until transposed by the Member States into their national laws. Following changes to the European supervisory architecture and the proposal to introduce a single rule book for financial services, the introduction of new EU rules relevant to financial services increasingly takes the form of directly applicable regulations.

II EUROPEAN REGULATORY AND SUPERVISORY FRAMEWORK

i Key EU institutions

a The European Commission (the Commission) represents the interests of the EU as a whole, and has the sole right to propose new legislation.

b The Council of the European Union (the Council) represents the interests of the individual Member States.

c The European Parliament (the Parliament) represents the interests of EU citizens, and is directly elected by them.

1 Nick Bonsall is a partner at Slaughter and May. The author would like to thank Sjoerd van der Zwaag and Kyle O'Sullivan for their assistance in preparing this chapter.

2 The EEA comprises the Member States of the EU and Iceland, Liechtenstein and Norway. Many European directives are extended to the non-EU Member States of the EEA by virtue of the Agreement on the European Economic Area, which came into force on 1 January 1994. New rules are adapted or extended to the EEA by decisions of the EU/EEA Joint Committee. EEA states outside the EU are informed of legislative proposals, but they do not have a formal role in shaping policy.

ii Legislative procedure

The Commission, after consultation with stakeholders, will put forward a legislative proposal for joint adoption by the Council and Parliament, which then usually goes through the ordinary legislative procedure (known as the co-decision procedure prior to the Treaty of Lisbon in 2009). In addition to its role in adopting legislation proposed by the Commission, the Parliament has a limited power to request the Commission to submit appropriate proposals on matters on which it considers that an EU legislative measure would be appropriate.

iii Lamfalussy approach to adoption of European financial services legislation

The Lamfalussy approach[3] is a four-level legislative procedure adopted by the EU for the development of legislation for the financial services industry that involves the following:

a legislative act (Level 1) – the framework legislation is proposed and adopted under the ordinary legislative procedure. Individual articles in the legislative act specify where power is delegated to the Commission to adopt Level 2 measures;
b implementing measures drafted and adopted by the Commission, following advice from the specialist committees (Level 2);
c consultation and guidance by the European Supervisory Authorities (Level 3); and
d supervision and enforcement, principally by the regulators in each Member State (Level 4).

iv Reform of the EU supervisory framework

Until 2011, three Level 3 Committees existed – the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors and the Committee of European Securities Regulators (CESR). These brought together regulators from each Member State to agree on the details of implementing measures and to coordinate the supervision of cross-border institutions. The failings in prudential regulation that were highlighted by the financial crisis led to criticism that these advisory committees did not have sufficient powers or influence to address the complex challenges of cross-border regulation.

Following recommendations contained in the 2009 de Larosière Report, the Commission proposed to establish a new European Systemic Risk Board, responsible for macro-prudential oversight, and a European System of Financial Supervisors, comprising three new pan-European Supervisory Authorities (ESAs) to replace the Level 3 Committees:

a the European Banking Authority (EBA);
b the European Insurance and Occupational Pensions Authority; and
c the European Securities and Markets Authority (ESMA).

The ESAs were established to oversee the financial system at a micro-prudential level and to achieve convergence between Member States on technical rules and coordination between national supervisors. The new authorities' powers go beyond those of the former Level 3 Committees and their role extends beyond being merely advisory. In March 2017 the Commission consulted on increased powers for the ESAs, including an extension of the EBA's powers to address disagreements over own funds requirements for banks and enhanced direct

3 Named after Alexandre Lamfalussy, who chaired the EU group that proposed the process for the development of EU securities legislation in 2001 (later extended to the field of banking, insurance and pensions regulation).

supervisory powers for ESMA with regard to certain capital markets segments including data providers, pan-European investment fund schemes and post-trading market infrastructures.[4] This consultation closed in May 2017, and responses have now been published.

Most notable of the three ESAs in this context is the ESMA, which replaced the CESR on 1 January 2011. The role of the CESR had been to improve coordination among securities regulators, to act as an advisory group to assist the Commission (in particular in the Commission's preparation of draft Level 2 implementing measures), and to work to ensure more consistent and timely day-to-day implementation of EU legislation in the Member States. As well as taking over all existing and ongoing tasks of the CESR, the ESMA has also been granted additional responsibilities and powers, including:

a the ability to draft technical standards in connection with specific areas of directives that are legally binding in Member States;

b the ability to launch a fast-track procedure to ensure consistent application of EU law;

c the ability in emergency situations to take decisions that bind national regulators or to intervene in the supervision of financial institutions in limited cases;

d new powers to resolve disagreements between national authorities; and

e additional responsibilities for consumer protection (including the ability to prohibit financial products that threaten financial stability or the orderly functioning of financial markets for a period of three months).[5]

III MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE REGIME

i Background

The Markets in Financial Instruments Directive (MiFID)[6] is a key component of the EU's Financial Services Action Plan that was introduced in 2000 to further the harmonisation of financial markets within the EU to facilitate a single market in financial services. Before the introduction of MiFID, the provision of investment services within the EU was regulated by the Investment Services Directive (ISD).[7] This sought to widen access to the financial services market by requiring Member States to permit investment firms that were established in other Member States to carry on the activities authorised by the home Member State in their territories through a passport. While it introduced the concepts of home Member State regulation and passporting of investment firms across the EU, it became increasingly clear over time that the scope of the ISD was too narrow to deal with the rapid evolution in financial markets that had occurred since its original enactment. In addition, the ISD was a minimum harmonisation directive, meaning there were still varying requirements across the EU as different Member States adopted different, often protectionist, approaches. MiFID has retained and seeks to expand the passporting framework introduced by the ISD.

ii Scope of MiFID

The implementation of MiFID had an important impact on investment firms across the EEA. MiFID expanded the scope of regulation of investment services, as MiFID applies to all EEA

4 Available at https://ec.europa.eu/info/sites/info/files/2017-esas-operations-consultation-document_en.pdf.

5 European Securities and Markets Authority, Frequently Asked Questions: A Guide to Understanding ESMA, 3 January 2011.

6 Directive 2004/39/EC.

7 Directive 93/22/EEC.

investment firms, which is defined as a legal person whose regular occupation or business is the provision of investment services or the performance of investment activities, or both, on a professional basis. The list of relevant investment services and investment activities that fall within the scope of MiFID includes various activities often undertaken by asset managers, such as receiving and transmitting orders relating to specified financial instruments, executing orders on behalf of clients, portfolio management and providing investment advice. The list of relevant financial instruments that fall within the ambit of the MiFID regime covers not only transferable securities such as shares, but also a wide range of other products, including money market instruments, units in collective investment undertakings and various forms of derivatives.

Investment managers accepting third-party portfolio mandates will typically be engaged in many of these activities and so will fall within the scope of MiFID. However, despite the wide definition of investment firms, there are also some important exemptions from the MiFID regime. For example, collective investment undertakings and the managers of such undertakings that are subject to the prescriptive requirements of either the undertakings for collective investment in transferable securities (UCITS) regime (see Section IV, *infra*) or the alternative investment funds (AIFs) regime (see Section V, *infra*), will be exempt.[8]

iii Core business standards

MiFID prescribes core business standards for firms providing investment services. These cover a wide range of issues, including:

a organisational requirements;
b regulation of outsourcing;
c management of conflicts of interest;
d processing of client orders and execution-only business;
e requirements for firms to assess the suitability and appropriateness of the financial services and products offered; and
f marketing communications.[9]

iv Client categorisation

A significant feature of the MiFID regime is the concept of client categorisation, whereby clients are categorised as either retail clients or professional clients, according to whether they meet specified criteria.[10] A professional client 'possesses the experience, knowledge and expertise to make its own investment decisions and [to] properly assess the risks that it incurs'.[11] Entities that require authorisation to operate in the financial markets will always be considered to be professional clients, and these include investment firms, other authorised financial institutions, and collective investment schemes (CIS) and their management companies.

8 In addition, entities that provide investment services solely for intra-group purposes do not fall within the scope of MiFID; neither does any person who deals solely on his or her own account, unless such a person is 'a market maker or deals on his own account outside a regulated market or multilateral trading facility on an organised, frequent and systematic basis by providing a system accessible to third parties in order to engage in dealings with them', by virtue of Article 2(1)(d) MiFID.

9 Articles 13, 18, 19, 21 and 22 MiFID.

10 Set out in Annex II MiFID.

11 Annex II preamble, MiFID.

In addition, large undertakings that satisfy two of the following criteria will also be considered professional clients:

a the balance sheet total for the entity is at least €20 million;

b the net turnover of the entity is at least €40 million; or

c the entity has own funds of at least €2 million.

Nonetheless, entities that are classified as professional clients under MiFID may still agree with investment firms that they are to be treated as non-professionals in order to ensure a higher degree of protection. At the same time, clients who do not fall within the definition of professional clients are entitled to waive certain protections that would otherwise be afforded to them as non-professional clients.[12]

MiFID also includes a subcategory of professional client known as an eligible counterparty, which is effectively an enhanced form of professional client who receive lower protection in relation to certain aspects of the MiFID regime. Eligible counterparties may include investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, and other financial institutions.[13] Certain obligations of investment firms are disapplied in respect of transactions involving eligible counterparties – for example, the duty to provide information about the investment firm's services and the obligation to execute a client's orders promptly, fairly and expeditiously are both excluded where the firm is providing execution-only services to an eligible counterparty.[14]

MiFID defines a retail client as a client who is not a professional client. Retail clients receive the highest level of regulatory protection under MiFID, and investment firms providing services to retail clients are subject to an extensive range of conduct of business requirements that are more onerous than those that apply to professional clients.

v Future outlook – MiFID II Directive and MiFIR

On 20 October 2011, the Commission published a package of proposals for reform, including a draft directive that would repeal and recast MiFID (MiFID II),[15] and the Regulation (MiFIR).[16] In the explanatory memorandum to the proposed MiFID II text, the Commission states that while MiFID has, in its view, been successful in increasing EU-wide competition in the trading of financial instruments, decreasing transaction costs and furthering market integration, nonetheless legislative reform of the MiFID regime would be desirable to address the challenges posed by an increasingly complex financial landscape. In particular, one result of the liberalisation of markets under the MiFID regime is that a great deal of trading of financial instruments takes place away from regulated trading venues such as regulated markets and multilateral trading facilities. In response to these developments, the Commission has identified investor protection and trading transparency as broad areas that require reinforcement by the new legislative provisions included in MiFID

12 Paragraph 2, Annex II MiFID.

13 Article 24(2) MiFID.

14 Article 24(1) MiFID.

15 Directive 2014/65/EU.

16 Regulation 600/2014.

II. MiFIR introduces directly applicable uniform rules in relation to certain areas, such as trade transparency and provision of investment services by third-country investment firms without branches inside the EU.

MiFID II and MiFIR were published in the Official Journal of the European Union (the Official Journal) and entered into force on 12 June 2014.[17] They will apply in January 2018, following a one-year delay because of challenges with implementation. Most of the detailed Level 2 measures have already been adopted and ESMA has now published initial drafts or final reports in respect of all the Level 3 measures. There are significant concerns within the UK asset management industry that the new measures will add significantly to costs while at the same time hampering competition and doing little to enhance investor protection.

Third-country branches

In the context of asset management, a significant change that will be introduced by MiFID II relates to the provision of MiFID-regulated investment services by third-country (i.e., non-EEA) firms that will be governed by the new Chapter IV of the recast Directive. Currently, such third-country firms are subject to national regimes in force in each Member State, but MiFID II harmonises the approach to be taken in this regard (subject to transitional arrangements in MiFIR that will allow existing third-country firms to continue to provide investment services in accordance with national regimes until three years after the adoption by the Commission of a decision in relation to the relevant third country).[18] In place of the national regimes, two new MiFID passports, for branches and cross-border services respectively, will be offered to third-country firms. The proposed criteria for the granting of these passports are set out below.

A third-country firm wishing to provide services to retail clients anywhere in the EU will be required to establish a branch (i.e., a physical establishment) somewhere in the EU.[19] MiFID II only permits the establishment of such a branch if certain specified conditions are met,[20] including that:

a the third-country firm is authorised and supervised in the third country in which it is established;

b there are cooperation arrangements in place for sharing information on supervisory and taxation matters between the third country and the relevant Member State;

c the relevant firm has requested membership of an authorised or recognised investor compensation scheme;

d sufficient initial capital is at the free disposal of the branch;

e all persons responsible for the management of the branch are appointed and they are of sufficiently good repute and possess sufficient knowledge, skills and experience; and

f the third-country firm belongs to an investor-compensation scheme authorised or recognised in accordance with the Directive on investor-compensation schemes.[21]

17 The MiFID II text can be found at: eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN. The MiFIR text can be found at: eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&qid=1404750981397&from=EN.

18 Article 54 MiFIR.

19 Article 39(1) MiFID II.

20 Article 39(2) MiFID II.

21 Directive 97/9/EC.

Once authorisation is granted by a Member State, the third-country firm will be able to provide the authorised investment services in other Member States without being required to establish branches in those jurisdictions in accordance with the passporting principle.

The principal criticism of MiFID II and MiFIR, in this context, is that they place European integration and a single market in financial services ahead of concerns about competition, in particular in relation to investment firms based outside the EU. It is certainly the case that the consequences of this legislation would be somewhat protectionist, limiting the capacity of investment firms based outside the EU to operate within the EU, including when communicating with EU-resident clients and potential clients.

Conduct of business

MiFID II also amends certain conduct of business provisions under MiFID, particularly in relation to investment advisory services and execution-only services. Under the new regime, investment firms providing investment advice will be required to specify whether their advice is being given on an independent basis and whether such advice has been based on a broad or restricted analysis of the market.[22] Advice will be deemed to be provided on an independent basis only if the investment firm has assessed a sufficient range of financial instruments available on the market before giving the advice (including products issued by entities other than issuers or product providers that have a close link to the relevant investment firm) and if the firm does not receive fees, commissions or other monetary benefits from any third party for the provision of advice.[23]

In addition, there is a new requirement under MiFID II for investment firms to specify how investment advice provided to a client meets the personal characteristics of that client.[24] MiFID II also introduces provisions to regulate cross-selling practices where investment firms offer investment services together with other services as part of the same package – firms will now be required to inform clients if it is possible to buy the constituent services in that package separately, and must also set out the costs of each separate component.[25]

The list of financial instruments that are considered to be non-complex for the purposes of the execution-only services exemption under MiFID is revised so that it is more likely that investment firms will be required to undertake an appropriateness assessment. In particular, shares in exchange traded funds and other structured UCITS will not be eligible for sale on an execution-only basis.[26]

The duties of investment firms to eligible counterparties is also strengthened so that investment firms are required to act honestly, fairly and professionally with eligible counterparties, and must communicate with them in a way that is fair, clear and not misleading.[27] In addition, the new regime will restrict the range of obligations that can be disapplied in respect of eligible counterparties; investment firms will now be required to provide the same appropriate information to such counterparties as is supplied to

22 Article 24(4) MiFID II.

23 Article 24(7) MiFID II.

24 Article 25(6) MiFID II.

25 Article 24(11) MiFID II.

26 Article 25(4)(a)(iv) MiFID II. Structured UCITS are UCITS that provide investors with algorithm-based returns that are linked to the performance of financial assets, indices or reference portfolios, or to UCITS with similar features.

27 Article 30(1) MiFID II.

other counterparties (including in respect of whether investment advice is provided on an independent basis, and on what basis a market assessment has been carried out, as well as the periodic communications specifying how any advice meets the personal requirements of the client).[28]

MiFID II also introduces more extensive provisions dealing with corporate governance of investment firms, strengthening the existing rules under the current MiFID regime. The new requirements are more prescriptive, and limit how many executive and non-executive directorships may be held by members of a firm's management body (subject to derogations permitted by the competent authorities of Member States).[29] In addition, larger and more complex investment firms may be required to establish nomination committees composed of non-executive directors to assess whether potential new directors have sufficient knowledge, skills and experience.[30] At the same time, ESMA is tasked with drafting detailed regulatory standards to clarify certain corporate governance concepts on which it published a consultation paper in October 2016.[31]

MiFID II also broadens the scope of regulation in several other areas, including:

a the regulation of a new type of trading venue, the organised trading facilities (OTFs), which will be subject to the same core requirements for a trading venue's operation as existing platforms and is defined broadly to capture all forms of organised trading not within existing categories;

b provisions of new safeguards for algorithmic and high-frequency trading activities;

c increasing the scope and level of transaction reporting obligations; and

d broadening the definition of financial instruments to include products such as structured deposits that are marketed to retail investors.

It is expected that MiFID II and MiFIR will result in significant changes to the current EU investment services landscape when implemented, particularly in relation to third-country investment firms providing services within the EU. While providing for a greater degree of harmony within the EU, the overall level of regulation seems likely to increase significantly, increasing costs and raising the barriers to new entrants in the sector. At the same time, MiFID II and MiFIR may significantly restrict the ability of firms based outside the EU to do business within it.

IV THE UCITS REGIME

i Background

The first UCITS Directive (UCITS I)[32] was introduced in 1985 as part of an initiative to create a cross-border single market in investment funds. UCITS I was designed to harmonise regulation of such schemes under a system of home state authorisation whereby Member States (host states) would permit UCITS schemes authorised in any other Member State (the home state) to be marketed in the host state without any further host state authorisation.

28 Ibid.
29 Article 9(1) MiFID II.
30 Ibid.
31 Ibid.
32 Council Directive 85/611/EEC.

In practice, however, a combination of differing taxation regimes and a protectionist approach by several Member States, first in the drafting of UCITS I, and then in its implementation, reduced its impact. However, Luxembourg was a major beneficiary as it introduced a fund-friendly and tax-neutral regime and became, as a result, the domicile of choice for European-based funds. At the same time, other developments in financial services regulation had led to more developed passporting rights for investment firms that fell within the ambit of the Investment Services Directive,[33] which were not available to managers of UCITS schemes. A particularly significant defect in UCITS I was that it did not contain rules requiring Member States to harmonise the regulation of marketing of UCITS schemes, which had the effect that while the schemes themselves would not need new authorisation in the host state, the relevant documentation that had to be supplied to investors nonetheless varied between different host state jurisdictions.

Against the background of these difficulties, two additional directives, the Product Directive[34] and the Management Company Directive,[35] were introduced in 2002. These widened the investment powers of UCITS schemes to permit investments in other UCITS and increased the permitted activities of UCITS management companies. The amended UCITS I is usually known informally as UCITS III (somewhat confusingly, as there was no official UCITS II – that term was used to describe a draft directive that was considered but could not be agreed and was withdrawn by the Commission in 1998).

ii UCITS IV[36] (as amended by UCITS V[37])

UCITS IV was introduced in 2009 in an attempt to accelerate the harmonisation of the EU asset management market and to address certain perceived defects of the UCITS III regime. UCITS IV aimed:

a to facilitate the provision of cross-border management services for UCITS funds in order to permit management companies incorporated and authorised in one Member State to manage a fund in a different Member State;
b to accommodate master-feeder structures within the UCITS regime;
c to facilitate cross-border mergers of UCITS funds;
d to strengthen the pre-investment disclosure requirements in respect of retail investors; and
e to simplify the notification rules for UCITS that are engaged in cross-border promotion.

Member States were required to transpose the provisions of UCITS IV into national law by 1 July 2011, although in October 2011 ESMA released an opinion discussing the consequences of the failure of Member States to complete the implementation process within the planned timetable.[38]

On 3 July 2012, the Commission announced a proposal (UCITS V Proposal) to amend UCITS IV and to address what it perceived as weaknesses in the UCITS regulatory regime.

33 Council Directive 93/22/EEC.
34 Council Directive 2001/108/EC.
35 Council Directive 2001/107/EC.
36 Directive 2009/65/EC.
37 Directive 2014/91/EU.
38 ESMA opinion, Practical arrangements for the late transposition of the UCITS IV Directive, 13 October 2011.

In particular, the Commission outlined its concern, in the wake of events connected with the Lehman Brothers bankruptcy and the Madoff scandal,[39] that UCITS allowed national laws too much flexibility to interpret the scope of the duties of UCITS depositaries and the liability for the negligent performance of those duties, with the result that there was an uneven patchwork for investors across the EU. In the UCITS V Proposal, the Commission also argues that the evolution of market practice and the investment environment within the EU has led to an increasing use of sub-custody arrangements, which may entail significant risk for funds as it remains unclear the extent to which a depositary is liable for sub-custodian losses. The Commission also refers to divergences as between national regulatory regimes and weaknesses that it believes are undermining the supervision of financial services within the EU, with the result that the Commission seeks to introduce proposals to set common minimum standards on important issues.

The UCITS V Directive was published in the Official Journal on 28 August 2014 and Member States were required to transpose the Directive into national law by 18 March 2016.

The following paragraphs set out an abstract of the UCITS rules as articulated at the European level.

iii Definition of a UCITS

A UCITS is an undertaking that has the sole object of collective investment in transferable securities or certain other specified financial assets that operate on the principle of risk-spreading; and has units that, at the request of their holders, are repurchased or redeemed, directly or indirectly, out of the undertaking's assets.[40]

A UCITS does not need to have a specific legal form, and may be established via contractual arrangements, trusts or companies incorporated under statute.

Certain types of funds, however, will always fall outside the scope of the UCITS regime. They include closed-ended investment funds and funds that raise capital without promoting the sale of their units to the public within the EU.[41]

iv Authorisation of a UCITS

The UCITS regime relies on the principle of home state authorisation and makes clear that a UCITS must be authorised by its home Member State, the competent authority of which must approve the constitution and rules of the fund, the depositary chosen to hold the fund's investments and, to the extent relevant depending on the type of UCITS, the management company.[42] Once the UCITS has been authorised by the home state, that authorisation is valid across all Member States of the EU.

---

39 The text of the explanatory memorandum to the proposal explains that Lehman Brothers International Europe, based in the UK, went into bankruptcy in 2008 while acting as sub-custodian in connection with the assets of a number of CIS. This raised a number of issues in relation to the relevant regulatory model that, while relating to non-UCITS funds, nonetheless had substantial similarities to the UCITS depositary regime. By contrast, the Madoff scandal did involve a UCITS feeder fund where the depositary had delegated the custody of its asset portfolio to a Madoff-operated entity, and Madoff himself also acted as the manager and broker on the fund's behalf. The Commission text states that this resulted in a loss of around €1.4 billion for the relevant fund.

40 Article 1(2) UCITS IV.

41 Article 3(d) UCITS IV.

42 Article 5 UCITS IV.

A particular irritation for some in the sector has been that some Member States have taken, and continue to take, a very long time to process applications, whether for new funds or to register overseas funds. In response to this, the UCITS IV regime provides that the competent authority of the home state must decide whether authorisation should be granted within two months of the submission of a completed application for authorisation being received. This may not, however, stop applications being delayed by Member States, as there is no sanctioning mechanism if a Member State fails to comply with this rule.

v Investment policies of a UCITS

UCITS IV applies restrictions to the investment policies of a UCITS, setting out a range of permitted investments that include:

a transferable securities and money market instruments that are admitted to or dealt on permitted regulated markets,[43] or that have been admitted to official listing on a stock exchange or are dealt with on another regulated market in a third country;[44]

b recently issued transferable securities, provided that these have been issued subject to terms requiring that an application will be made for them to be admitted to official listing on a suitable stock exchange or other suitable regulated market,[45] and they are admitted within a year of issue;

c units of other UCITS (thereby permitting funds of funds);

d units of other CIS provided that these meet certain conditions (essentially an equivalent level of protection for unitholders to that provided for unitholders of a UCITS);

e deposits with credit institutions that can be withdrawn or are repayable on demand, or that mature in no more than 12 months. The relevant credit institution must either have its registered office inside the EU or in a third country where it is subject to prudential rules considered by the competent authorities of the UCITS's home state to be equivalent to the prudential requirements laid down in EU law (an approved credit institution);

f financial derivatives (which may be dealt with on a suitable regulated market or may be over-the-counter (OTC) derivatives), provided that these meet certain specified requirements; and

g certain money market instruments that are not dealt on a regulated market but that are issued by entities meeting certain specified criteria (which essentially cover low-risk issuers such as central banks, issuers listed on certain regulated markets or issuers who meet certain minimum capital requirements).

43 These include regulated markets as defined in Article 4(1)(14) of MiFID, and any other regulated markets in EU Member States that operate regularly and that are recognised and open to the public.

44 Provided that such exchange or market has been approved by the relevant competent authorities, or is otherwise provided for in law, in the rules of the fund or in the instrument of incorporation of the investment company (Article 50(1)(c) UCITS IV).

45 Any such regulated market must operate regularly and be recognised and open to the public. The stock exchange or regulated market must also have been approved by the competent authorities, or have been provided for in law or the rules of the fund or in the instrument of incorporation of the investment company (Article 50(1)(d)(i) UCITS IV).

The investments eligible for UCITS investment have frequently been interpreted differently in Member States, and this has been a cause of friction and confusion, so much so that the Eligible Assets Directive[46] was introduced in 2007 in an attempt, not yet wholly successful, to improve consistency in relation to eligible and ineligible investments.

In addition to prescribing eligible investments, the UCITS regime includes rules on concentration of investments so that all UCITS meet a minimum level of investment diversification. These are:

a no more than 5 per cent of the assets of the UCITS can be invested in transferable securities or money market instruments issued by the same body (although Member States are permitted to raise this limit to 10 per cent on the condition that the total value of the transferable securities and money market instruments held by the UCITS in the issuing entities in which it holds over 5 per cent of its assets do not in the aggregate exceed 40 per cent of the value of the UCITS's assets);

b no more than 20 per cent of the assets may be held in transferable securities and money market instruments issued by entities belonging to the same group;

c the exposure from OTC derivatives transactions to any one counterparty must not exceed 5 per cent of the assets (or 10 per cent where the counterparty is an approved credit institution);

d no more than 20 per cent of the assets may be invested in a single body;

e the limits in (a) above may be relaxed so a UCITS may invest up to 35 per cent of its assets in transferable securities or money market instruments that are issued or guaranteed by a Member State, its local authorities, the government of a third-party country or a public international body of which a Member State is a member;[47] and

f if permitted by its relevant Member State, the limit in (a) above may be relaxed in respect of bonds issued by a credit institution that has its registered office in a Member State and is subject to public legal supervision designed to protect its bondholders so that the UCITS may invest up to 25 per cent of its assets in such bonds. However, if more than 5 per cent of the UCITS's assets are invested in bonds issued by a single issuer, the total value of its investment in all such bonds must not exceed 80 per cent of the total value of its assets.[48]

Member States are permitted to derogate from the limit in (e) above and to authorise UCITS to invest up to 100 per cent of their assets in government securities if they consider that the unitholders of the UCITS have equivalent protection to that of the unitholders in a UCITS that did comply with the general limits.

In addition, a UCITS is permitted to invest in the units of other UCITS or other permitted CIS provided that no more than 10 per cent of its assets are invested in a single UCITS or other CIS. Member States are permitted to raise this limit to 20 per cent of the assets of the UCITS.[49]

These investment restrictions are considerably less onerous than the original restrictions contained in UCITS I. This has led to the evolution of the newcits phenomenon, whereby

46 2007/16/EC.

47 Under Article 52(5) UCITS IV, such government securities or money market instruments do not need to be taken into account when the 40 per cent limit referred to in (a) is applied.

48 Article 52(4) UCITS IV.

49 Article 55(1) UCITS IV.

hedge funds have begun to take advantage of the ability to market themselves across the EU using the UCITS regime. In particular, it has become possible for UCITS to take an economic exposure in underlying hedge funds through the use of OTC derivatives (which under UCITS I were only permitted as a means of portfolio management and were not allowed to be used as investments in themselves), allowing retail investors to effectively invest in hedge funds through the UCITS structure. This has led to calls for UCITS to be split into complex and simple categories, with the former requiring more detailed risk warnings if they are to be sold to retail investors.

vi UCITS management companies

Like UCITS themselves, UCITS management companies must be authorised by the competent authorities of their home state, but once granted such authorisation is valid throughout the EU.[50]

Management companies may only carry out a limited range of activities, which consist principally of management of UCITS and other CIS (where subject to prudential supervision) and, where permitted by the relevant Member State, certain other services, such as investment management of certain permitted investment portfolios or other non-core services providing investment advice in relation to certain permitted investments and safeguarding and administering units in CIS.[51]

Management companies must meet the following requirements before authorisation may be granted by the relevant Member State:

a the management company must have an initial capital of at least €125,000 (plus an additional 0.02 per cent of the amount by which the portfolios under management by the company exceed €250 million, provided that the total required initial capital does not exceed €10 million);[52]

b the individuals who conduct the business of the management company must be of sufficiently good repute and sufficiently experienced in relation to the type of UCITS being managed;[53]

c the head office and the registered office of the management company must be located in the same Member State;[54]

d if the management company has close links with other natural or legal persons, those links must not prevent the effective exercise of the supervisory functions of the relevant home state regulator;[55]

e the home state competent authorities must be provided with the identities and holding amounts of all shareholders or members who hold, directly or indirectly, 10 per cent or more of the capital or voting rights in the management company, and the competent authorities must be satisfied that such shareholders or members are suitable;[56] and

50 Article 6(1) UCITS IV.
51 Article 6(3) UCITS IV.
52 Article 7(1)(a) UCITS IV.
53 Article 7(1)(b) UCITS IV.
54 Article 7(1)(d) UCITS IV.
55 Article 7(2) UCITS IV.
56 Article 8(1) UCITS IV.

f if the management company is a subsidiary, or controlled by the same person that controls an investment firm, credit institution or insurance undertaking authorised in another Member State, the competent authorities of that other Member State must be consulted before any authorisation is granted.[57]

In addition to meeting the initial requirements for authorisation, UCITS management companies must also meet certain ongoing operating conditions. Broadly speaking, these require management companies to:

a maintain minimum levels of regulatory capital;[58]

b observe prudential rules drawn up by the Member State in which the management company has been authorised;[59]

c have sound administrative and accounting procedures;[60]

d minimise conflicts of interest between itself and a client, between two of its clients, between a client and the underlying UCITS being managed and between two UCITS;[61] and

e establish proper procedures to handle investor complaints and ensure that the rights of investors to complain are not restricted as a result of the fact that the management company may be authorised in a Member State other than the home Member State of the relevant UCITS.[62]

UCITS IV sets out principles that UCITS management companies must comply with when establishing and applying their remuneration policies. For example, UCITS management companies must have remuneration policies that promote sound and effective risk management and do not encourage risk-taking or impair the management company's duty to act in the best interests of the UCITS.[63] At least half of the variable part of the remuneration of management companies must be paid in assets of their UCITS, unless the management of the UCITS accounts for less than half of the total portfolio.[64] Payment of at least a further 40 per cent of this variable remuneration (or 60 per cent if the variable remuneration is of a particularly high amount) is to be deferred for a minimum of three years[65] to encourage managers to take a long-run view. ESMA published further guidelines on these remuneration principles in March 2016, which came into force in January 2017.[66]

UCITS IV also contains detailed provisions relating to the freedom to provide cross-border services and the freedom of establishment for management companies within the EU. These make clear that a UCITS is free to be managed by a company that is authorised in a

57 Article 8(3) UCITS IV.

58 Article 10(1) UCITS IV.

59 Article 12(1) UCITS IV.

60 Article 12(1)(a) UCITS IV.

61 Article 12(1)(b) UCITS IV.

62 Article 15 UCITS IV.

63 Article 14a UCITS IV.

64 Article 14b(1)(m) UCITS IV.

65 Article 14b(1)(n) UCITS IV.

66 Available at www.esma.europa.eu/sites/default/files/library/2016-411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd_0.pdf.

Member State other than the UCITS's home Member State,[67] while management companies are also permitted to establish branches in other Member States subject to compliance with certain notification requirements.[68]

vii UCITS depositaries

UCITS must entrust the safe custody of their assets to a depositary for safekeeping.[69] It is the responsibility of the depositary to ensure the following:

a sales, issues, repurchases, redemptions and cancellations of the units effected on behalf of a common fund comply with applicable national laws and the fund's constitution and rules;
b the value of the units is calculated in accordance with applicable national law and the fund's constitution and rules;
c any instructions of the management company are carried out, unless they conflict with applicable national laws or the fund's constitution and rules;
d any sums due to the fund or securities acquired are remitted to the fund within specified time limits; and
e income is applied in accordance with applicable national laws and the fund's constitution and rules.

The depositary must have its registered office or must be established in the home state of the UCITS.[70] The depositary must also be a national central bank, a credit institution authorised under the CRD IV Directive[71] or an entity authorised by the national competent authority to carry out depositary activities. An entity authorised to carry out depositary activities shall be subject to capital adequacy requirements and own funds requirements, prudential regulation and ongoing supervision, and must also satisfy certain minimum requirements, including establishing policies and procedures to ensure compliance with UCITS IV, and for all members of its management body and senior management to be of sufficiently good repute and possess sufficient knowledge, skills and experience.

UCITS IV prohibits an entity from acting as both the management company and the depositary of a UCITS, and the entities fulfilling these roles must act independently and solely in the interests of the unitholders.[72]

In relation to sub-custody, Article 24 of UCITS IV previously stated that a depositary shall be liable for loss as a result of its 'unjustifiable failure to perform its obligations or its improper performance of them'. This wording was interpreted differently by Member States, as was highlighted in the Madoff insolvency when Luxembourg-based depositaries were found to have a materially lower level of duties when compared with their French equivalents. To address this divergence, UCITS V amended UCITS IV to clarify when a depositary's duties can be delegated to a sub-custodian. Article 24 of UCITS IV now provides that a depositary's liability for the loss of financial instruments held in custody is not generally affected by delegation to a sub-custodian, and a depositary is not able to exclude its liability

67 Article 16(3) UCITS IV.
68 Article 17 UCITS IV.
69 Articles 22 and 32 UCITS IV.
70 Article 23(1) UCITS IV.
71 2013/36/EU.
72 Article 25 UCITS IV.

through contractual arrangements. However, a depositary will not be liable if it can show that the loss is a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. UCITS V explicitly notes that this liability of depositaries differs from the position under the Alternative Investment Fund Managers Directive (AIFMD)[73] (particularly in relation to contractual modification of liability), but explains that as the UCITS regime is designed to protect retail investors, such a divergence is justifiable.

In December 2015, the Commission adopted a Delegated Regulation[74] setting out the detailed Level 2 measures that relate to depositaries. The Delegated Regulation has been applicable since 13 October 2016 and includes provisions relating to:

- *a* the minimum requirements for contracts between the management company or the investment company and the depositary;
- *b* obligations on the depositary relating to oversight, due diligence, segregation and insolvency protection;
- *c* the conditions and circumstances in which financial instruments held in custody are considered to be lost and how the depositary can discharge its liability; and
- *d* independence requirements for management companies, investment companies, depositaries and third parties to whom the safekeeping function has been delegated.

It is clear that, as a result of the changes introduced by UCITS V and those introduced by the Delegated Regulation, there is greater exposure for depositaries. The consequences remain open to question, with some predicting significant fee increases and others the concentration of depositories to a very small number of global custodians who have the expertise and coverage necessary to provide the enhanced level of protection; the answer is likely to be a combination of both.

viii UCITS mergers

Chapter VI of UCITS IV contains rules designed to facilitate both domestic and cross-border mergers of UCITS funds. There are three different methods of merging UCITS:[75]

- *a* a UCITS (the merging UCITS) is dissolved without going into liquidation, and transfers all of its assets and liabilities to a second UCITS in exchange for the issue of units to its unitholders (with, if applicable, a cash payment not exceeding 10 per cent of the net asset value);
- *b* two UCITS are dissolved without going into liquidation, and transfer all of their assets and liabilities to a new UCITS in exchange for the issue to their unitholders of units (possibly with a cash payment, not exceeding 10 per cent of the net asset value); or
- *c* a UCITS transfers its assets to a newly formed UCITS or another existing UCITS, but is not dissolved and continues to exist until its liabilities have been discharged.

A merger must be authorised by the competent authorities of the home Member State of each merging UCITS. Those authorities must be provided with certain key information, including

73 2011/61/EU.

74 European Commission Delegated Regulation (EU) No. 2016/438.

75 These methods also apply, *mutatis mutandis*, to the merger of investment compartments of UCITS.

the terms of the proposed merger.[76] The competent authorities of the merging UCITS's home Member State will then forward that information to the competent authorities of the other UCITS's home Member State, who may require that the information to be given to unitholders is modified.

The competent authorities of the home state of the merging UCITS must authorise the merger if:

a the competent authorities in the home states of both the merging and receiving UCITS are satisfied with the information that it is proposed to be provided to unitholders;

b the receiving UCITS has been approved to market its units in the Member State and in all Member States where the merging UCITS has been approved to market its units; and

c certain other requirements have been met, such as the validation of the criteria used to value the assets of the relevant UCITS in order to calculate the relevant exchange ratio by the depositary.

If the national laws of Member States require unitholders to vote to approve the merger, the approval must not require more than 75 per cent of the votes cast at a unitholders' general meeting.[77] The quorum requirements cannot be more onerous for cross-border UCITS mergers than for domestic UCITS mergers and cannot be more onerous for UCITS mergers than for corporate mergers.

In practice, the merger of a UCITS is a process hampered by bureaucratic and taxation hurdles, despite the rules in UCITS IV. These hurdles include the costs involved in notifying all the investors in funds that are merging, the time delay in obtaining regulatory approval for the communications to investors, and the differing tax treatments of the portfolio transfer, cancellation and issue of units. Despite the undoubted scope for cross-border fund mergers – European funds are typically much smaller and more expensive than their counterparts in North America – there has been no significant increase in merger activity. Whether the taxation and bureaucratic impediments to a more efficient investment fund market within the EU can be removed, or at least materially reduced, depends on the politics of individual Member States; however, the omens are not favourable, at least in the short term.

ix Master-feeder UCITS structures

UCITS IV allows the use of a feeder UCITS. These are UCITS that, by way of exception to the general rules preventing concentrations of investment by a UCITS, are permitted to invest up to 85 per cent of their assets in another UCITS (a master UCITS).[78] The 15 per cent balance may be held in ancillary liquid assets, derivatives used only for hedging purposes

76 Article 39(2) UCITS IV. Under Article 39(5), if the competent authorities of the merging UCITS's home Member State consider that the information provided is not complete, they may request additional information within 10 working days of receiving the original information. The merging and receiving UCITS are required to draw up common draft terms of merger under Article 40.

77 Article 44 UCITS IV.

78 Article 58(1) UCITS IV.

or property that is essential for the direct pursuit of the business.[79] A master UCITS must have at least one feeder UCITS among its unitholders, may not itself be a feeder UCITS and may not hold units in any feeder UCITS.[80]

Before a feeder UCITS can invest in a master UCITS, it must obtain the approval of the competent authorities of the feeder UCITS's home state.[81] If the feeder UCITS is established in a different Member State, the feeder UCITS must obtain an attestation from the competent authorities of the Member State of the master UCITS that the master UCITS is not a feeder UCITS and has not invested in a feeder UCITS.[82]

The feeder UCITS is required to enter into an agreement with the master UCITS under which the master UCITS will supply the feeder with all necessary documents and information required under the master-feeder relationship.[83] Where the master and feeder UCITS use different depositaries, those depositaries must also enter into an agreement to share information in order to allow both depositaries to fulfil their duties under UCITS IV.[84]

These provisions, while bureaucratic and time-consuming to satisfy, nevertheless do represent a welcome change given the many benefits, in particular from economies of scale, that master-feeder structures can deliver. In the context of Europe, feeder structures are expected to be used principally to reflect the differing taxation regimes applicable to investors depending on their respective Member State. It is expected that they will be an increasing feature of investment fund structures until the full harmonisation of personal and institutional taxation (which is a very unlikely prospect).

x Investor information requirements

Chapter IX of UCITS IV contains requirements about the information that must be provided to UCITS investors. Broadly speaking, a UCITS must publish a prospectus, an annual report for each financial year within four months of the end of that year and a half-yearly financial report within two months of the half-year end.[85]

The prospectus is required to contain all the information necessary for investors to make an informed judgement about investing in the UCITS and the risks attaching to that investment. In addition, independently from the information provided about the investment instruments themselves, the prospectus must contain a clear explanation of the general risk profile of the UCITS and the details or summary of the remuneration policy.[86] The minimum content requirements for prospectuses are set out in Schedule A of Annex 1 of UCITS IV, including those related to general details of the UCITS, the rights attaching to units, its investment objectives, and its rules relating to income and asset valuation. The prospectus must also indicate the categories of assets in which the UCITS is permitted to invest and explain its approach to the use of derivatives.[87]

79 Article 58(2) UCITS IV.
80 Article 58(3) UCITS IV.
81 Article 59(1) UCITS IV.
82 Article 59(3) UCITS IV.
83 Commission Directive 2010/42/EU.
84 Article 61 UCITS IV.
85 Article 68 UCITS IV.
86 Article 69(1) UCITS IV.
87 Article 70(1) UCITS IV.

The annual report of a UCITS must include a balance sheet or a statement of assets and liabilities, an income and expenditure account for the relevant financial year, a report on its activities during the financial year, and information on the number of units in circulation, the net asset value per unit and comparative tables showing that information for the past three financial years. There are also content rules for half-yearly reports.

In addition, UCITS IV introduced a requirement for UCITS to provide key investor information to investors, designed to assist them in making key investment decisions on an informed basis. This document must contain certain essential elements, including:

a identification of the UCITS and its competent authority;
b a description of its investment objectives and its investment policy;
c a presentation of the UCITS's past performance or performance scenarios;
d the UCITS's costs and associated charges; and
e a risk-reward profile of the investment in the UCITS, including any appropriate guidance and warnings in relation to the risks that are associated with any investments in the UCITS.[88]

The information must be presented in a manner comprehensible to an investor without requiring reference to information in any other documents. There is a general requirement for all key investor information to be written in concise and non-technical language, drawn up in a common format to allow for easy comparison by investors.[89] To encourage consistency, ESMA provides a template on its website that may be used as the basis of a key investor information document (KIID).[90]

Investors (in particular retail investors) will receive, before units can be purchased, the KIID, on the principle that the UCITS structure is simple enough and sufficiently well regulated that the KIID provides enough basic information to permit an informed investment decision. In particular, the principal advantage of the KIID may prove to be that it can be used as a pan-European template, although language differences may limit the possibilities for economies of scale.

Sanctions for breach of UCITS requirements

UCITS IV sets out broad categories of UCITS breaches for which national regulators must provide penalties, and lists the administrative sanctions and measures that competent authorities should be empowered to apply, including:

a public warnings or statements of censure identifying the person responsible and the nature of the breach;
b temporary suspension or permanent withdrawal of UCITS or management company authorisation;
c effective, proportionate and dissuasive administrative pecuniary sanctions up to a maximum of €5 million or 10 per cent of annual turnover for companies and up to a maximum of €5 million for individuals; and
d fines of up to twice the amount of any profits gained or losses avoided as a result of the breach.[91]

88 Article 78(3) UCITS IV.
89 Article 78(5) UCITS IV.
90 www.esma.europa.eu/content/CESR%E2%80%99s-template-Key-Investor-Information-document.
91 Article 99(6) UCITS IV.

The competent authorities of Member States will be required to publish any sanctions or measures imposed, and simultaneously report to ESMA, which should also publish an annual report on all sanctions imposed.

xi Future outlook – UCITS VI proposal

In July 2012, shortly after the UCITS V legislative proposal, the Commission published a consultation on UCITS VI. The consultation did not contain any specific proposals, but asked general questions on the following areas:

a eligible assets and the use of derivatives;
b efficient portfolio management techniques;
c OTC derivatives;
d extraordinary liquidity management rules;
e a depository passport;
f money market funds (MMFs);
g long-term investments; and
h improvements to elements of UCITS IV.

In particular, the consultation focused on self-managed investment companies, master-feeder structures, fund mergers and notification procedures.

The Commission has received responses to the consultation, but has not yet published a legislative proposal. The Commission's work programme for 2017 contained no references to UCITS VI, and it is unclear when, or indeed if, a UCITS VI proposal will be published.

V THE AIFMD

i Background

Even before the onset of the financial crisis, EU politicians, and to a lesser extent regulators, had sought to review regulatory policy in relation to the AIF industry, which was rapidly expanding and was seen by many as an unregulated segment of the financial services market. There were concerns related to lack of transparency, short-termism, remuneration practices and the potential threat to financial stability posed by hedge funds that employ overly high levels of leverage. There was also criticism of the private equity industry and the perceived (at least by some) negative consequences on the target companies of leveraged buyouts in which the target company's assets are used to repay the acquisition financing. The onset of the financial crisis provoked a global regulatory consensus on the need to reform the shadow banking sector and fuelled a renewed focus on the activities (and regulation) of the AIF industry.

After 18 months of political debate within the EU institutions, on 11 November 2010 the Parliament adopted a final, agreed text of the AIFMD, which was formally approved by the Council on 27 May 2011. The AIFMD came into force on 21 July 2011, and the deadline for implementation by Member States was 22 July 2013. As the AIFMD is a directive, it is not directly applicable, and Member States must implement it into national law.

The stated objective of the AIFMD is to ensure that all managers of AIFs are authorised and subject to harmonised regulatory standards across the EU. Note that the AIFMD regulates fund managers operating within the EU rather than directly regulating the funds themselves, many of which may be based offshore.

A particular complication is that the vast majority of hedge funds managed within the EU are managed from London, which is also responsible for a significant portion of other non-UCITS investment funds marketed or managed in the EU. There is widespread concern, not least in London, that this very successful industry may be harmed by regulation that places more emphasis on harmonisation than on international competitiveness.

ii Overview of the AIFMD

The AIFMD applies to AIFMs, meaning any person whose regular business is managing one or more AIFs. Managing means the provision of portfolio management services and risk management services, and an AIF is any collective investment scheme that is not covered by the UCITS regime.[92] As well as applying to AIFMs that manage or market AIFs (wherever those funds are established) in the EU, the AIFMD also applies to AIFMs established outside the EU that manage AIFs established in the EU, and to non-EU AIFMs that market one or more AIFs (wherever established) within the EU.[93] The AIFMD has a very wide scope, with few exemptions, but AIFMs that manage AIFs the value of whose assets under management fall below specified thresholds are exempt from most of the provisions of the AIFMD.[94]

Key features of the AIFMD include:

a AIFMs that manage AIFs must be authorised. To be authorised, an AIFM must, among other conditions, exceed minimum capital requirements;
b restrictions on the levels of remuneration for senior management and risk-takers;
c AIFMs must be able to show that specific safeguards are in place against conflicts of interest;
d AIFMs will be required to manage and monitor liquidity risk and conduct regular stress tests;
e AIFMs will be required to set a maximum level of leverage for each AIF;
f there will be extensive requirements in relation to the valuation of managed assets, delegation of the AIFM's functions and the use of a depositary to safeguard the AIF's assets;
g there will be business conduct principles for AIFMs, including requirements to act with due skill, care and diligence, and to act in the best interests of the AIF and its investors;
h there will be a requirement to produce annual reports, and to make disclosures to investors and regulators on an ongoing basis;
i there will be restrictions on asset stripping; and
j there will be a marketing and passport regime that will, for the first time, enable an EU AIFM authorised in its home state to manage and market EU AIFs both domestically and in other Member States without requiring additional authorisation in those other Member States.[95]

92 Article 4(1)(a) and (b) AIFMD.
93 Article 2(1) and (2) AIFMD.
94 Articles 2 and 3 AIFMD.
95 Marketing is defined in the AIFMD as the direct or indirect offering or placement of units or shares in an AIF to, or with, investors domiciled in the EU. Significantly, this does not include marketing that is independent of the AIFM marketing to investors outside the EU or passive marketing, where the initiative is taken by the investor rather than the AIFM.

Details on the key features of the AIFMD listed above, as implemented in the national law of Member States, are outlined in the national chapters.

iii Level 2 measures and Level 3 guidance

The provisions of the AIFMD outline the framework of the regime, but the details have been determined by Level 2 implementing measures.

The Commission has adopted a delegated regulation[96] on exemptions, general operating conditions, depositaries, leverage, transparency and supervision. This regulation is directly applicable in all Member States and has applied since 22 July 2013. The delegated regulation includes provisions relating to:

a the calculation of assets under management and leverage;
b additional own funds and professional indemnity insurance;
c conflicts of interest;
d risk and liquidity management;
e delegation of AIFM functions;
f the obligations and rights of depositaries; and
g transparency obligations to both investors and supervisory authorities.

The contents of the delegated regulation depart from ESMA's original advice, which has attracted criticism from a number of Member States, including the UK.[97]

The Commission adopted a delegated regulation to determine types of AIFMs, whether an AIFM is an AIFM of open-ended AIFs or closed-ended AIFs, and to ensure uniform conditions of application of the AIFMD on 17 December 2013.[98] In addition, the Commission adopted a delegated regulation on the information to be provided by national competent authorities to ESMA, which entered into force on 16 April 2015.[99]

This extremely important concession will allow European pension funds and other experienced investors to access hedge funds, in particular the 70 per cent managed in the US, without the funds having to comply with the AIFMD. Unfortunately, this – and the resulting compliance costs – equally seems likely to put European-managed hedge funds at a potentially significant competitive disadvantage.

The question of whether to make the passporting regime available in respect of non-EU AIFs and AIFMs was the subject of heated debate prior to the publication of the AIFMD. The compromise that was adopted involves the deferral of the non-EU passporting provisions set out in the AIFMD. This was initially expected to be deferred until 2015, though this has since been delayed until further notice. ESMA published preliminary advice on the extension of the passporting regime in July 2015 and final advice in July 2016. The European Commission has so far not acted upon the final advice provided by ESMA, and in the meantime national private placement regimes will continue to operate. ESMA did publish a report on the findings of its thematic study on notification frameworks and home-host responsibilities under UCITS IV and the AIFMD in April 2017, which aims to facilitate the smooth operation of EU passports for marketing and management of UCITS and AIFs.

96 European Commission Delegated Regulation (EU) No. 231/2013.

97 See a Council statement of February 2013, available at register.consilium.europa.eu/pdf/en/13/st06/st06687-ad01.en13.pdf.

98 Available at ec.europa.eu/internal_market/investment/docs/alternative_investments/131217_delegated-regulation_en.pdf.

99 Available at eur-lex.europa.eu/ legal-content/EN/TXT/PDF/?uri=CELEX:32015R0514&from=EN.

The Commission has also adopted two implementing regulations, one to establish a procedure for determining the Member State of reference of a non-EU AIFM[100] and the other to establish the procedure for AIFMs to opt in under the AIFMD.[101]

To supplement these Level 2 measures, ESMA has issued Level 3 guidelines. These provide guidance to national regulators in the EU as to how to implement directives, regulations and technical standards (Level 1 and 2 measures). While the guidelines are not legally binding, regulators and market participants should make every effort to comply with them. National regulators are required to incorporate these guidelines into their supervisory practices or explain why they have not done so.

On 11 February 2013, ESMA published Level 3 guidelines on sound remuneration policies under the AIFMD.[102] A final report on the revision of these guidelines was published in March 2016 and the amended guidelines came into force on 1 January 2017.[103] ESMA has also published guidelines on key concepts of the AIFMD[104] that give guidance on the concepts in the definition of an AIF,[105] and guidelines[106] on reporting obligations under the AIFMD that set out the information AIFMs should report to regulators and the times when reports must be made.

VI SOLVENCY II

i Current regime

The insurance sector is a key provider of the funds under discretionary fund management. This reflects the fact that insurers hold assets and capital to meet their liabilities to policyholders and satisfy their regulatory capital requirements.

ii Overview

The Solvency II Directive (Solvency II)[107] came into force on 1 January 2016 and introduces a new, harmonised EU-wide insurance regulatory regime, replacing various EU insurance directives including the Recast Life Directive[108]. The key objectives of Solvency II are improved protection of policyholders; a move towards a more risk-based approach to prudential regulation; and harmonisation of national supervisory regimes.

Further detail of the regime is set out in the Solvency II Delegated Regulation (Level 2), which was published by the Commission on 10 October 2014 and came into force on

100 Commission Implementing Regulation (EU) No. 448/2013.

101 Commission Implementing Regulation (EU) No. 447/2013.

102 Available at www.esma.europa.eu/system/files/2013-201.pdf.

103 Available at www.esma.europa.eu/sites/default/files/library/2016-411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd_0.pdf.

104 Available at www.esma.europa.eu/system/files_force/library/2015/11/2013-611_guidelines_on_key_concepts_of_the_aifmd_-_en.pdf?download=1.

105 Article 4(1)(a) AIFMD.

106 Available at www.esma.europa.eu/sites/default/files/library/2015/11/2014-869.pdf.

107 Directive 2009/138/EC.

108 Directive 2002/83/EC

18 January 2015.[109] The European Insurance and Occupational Pensions Authority has published Implementing Technical Standards and Guidelines supplementing Level 1 and Level 2.

The Solvency II regime is divided into three areas, known as pillars: quantitative requirements; governance, risk management and supervisory review; and disclosure and transparency.

It applies to all EU insurers and reinsurers, subject to some very limited exceptions.[110]

Capital requirements

Firms are required to establish technical provisions reflecting their expected future liabilities to policyholders and to hold assets sufficient to cover those technical provisions.[111] In addition, firms need to have capital to cover the minimum capital requirement (MCR), which is the minimum level of solvency below which a firm risks the withdrawal of its authorisation, and the solvency capital requirement (SCR), which is a higher level of capital below which supervisory intervention will be triggered. In exceptional circumstances, national supervisors have the discretion to require an insurer to maintain further capital in addition to the SCR, known as the capital add-on. The types of capital (referred to in Solvency II as own funds) that insurers may use to satisfy the MCR and SCR are classified by means of a system that classifies own funds into three tiers according to the extent to which they possess the characteristics of permanent availability and subordination, with Tier 1 being the highest of the tiers. Limits will apply to the amounts of Tier 2 and Tier 3 own funds that can be used to meet a firm's capital requirements.

The SCR can be calculated either in accordance with a standard formula detailed in the Level 1 text (with greater detail in the corresponding Level 2 implementing measures) or using an internal model developed by the undertaking and approved by the relevant supervisory authority. The SCR calculated on the basis of the standard formula comprises a basic solvency capital requirement, a capital requirement for operational risk and an adjustment for the loss-absorbing capacity of technical provisions and deferred taxes.[112] The basic solvency capital requirement consists of various risk modules including to cover underwriting risk, market risk and counterparty default risk.[113] The market risk module is based on stress testing of the insurer's assets, the results of which govern the level of capital charge that particular assets will attract. Quantitative impact study 5, undertaken by the European Insurance and Occupational Pensions Authority to assess the impact of the new regime, highlighted potentially higher capital charges for the following types of investment (relative to assets with similar risk profiles):

- *a* property;
- *b* other equities, which include most hedge funds, commodities and equities not listed in the EEA;
- *c* non-EEA sovereign bonds; and
- *d* structured products such as mortgage-backed securities.

109 Available at: eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2015:012:FULL&from=EN.

110 Article 4 Solvency II.

111 See Section 2, Chapter VI Solvency II.

112 Article 103 Solvency II.

113 Article 104 Solvency II.

There has been speculation that these capital requirements may change an insurer's asset allocation as the new capital charges focus attention on the balance of risk and reward within investment portfolios.

Prudent person principle

The concept of admissible assets no longer applies under Solvency II. Instead, it is replaced by a prudent person principle, which provides requirements relating to the investment of insurers' assets. The key requirements are that:

a insurers only invest in assets and instruments whose risks can be properly monitored, managed and controlled;

b all assets must be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole;

c derivative instruments may be used only insofar as they contribute to reduction of risks or facilitate efficient portfolio management; and

d assets held to cover technical provisions shall be invested in a manner appropriate to the nature and duration of the insurer's liabilities, and in the best interests of policyholders and beneficiaries.[114]

The matching requirements for linked contracts contained in the Recast Life Directive have been carried over into Solvency II. Linked business is also subject to the prudent person principle, subject to some exceptions.[115] In particular, the restriction on the use of derivatives will not apply. Limitations have also been introduced on the extent to which Member States can restrict the types of assets or reference values to which policy benefits may be linked (permitted links). Under Solvency II, Member States cannot restrict linked policies issued to institutional policyholders, and cannot for any linked policies impose greater investment restrictions than those applicable to a UCITS under the UCITS Directive.[116]

Look-through principle

Solvency II introduces a greater focus on transparency of investments, involving a look-through approach to risk assessment whereby, for the purposes of the SCR calculation, the underlying investments held by investment funds in which an insurer is invested are treated as direct holdings.[117] This may be a challenge for managers of funds of funds as, if insurers are to invest, the managers will need to be able to provide detailed information on the underlying portfolio.

Disclosure and reporting

Firms are required to produce a solvency and financial condition report on an annual basis, which must contain the following information in relation to a firm:

a its business and performance;

b its system of governance and an assessment of its adequacy for the risk profile of the firm;

114 Article 132 Solvency II.

115 Article 132(4) Solvency II.

116 Article 133(3) Solvency II.

117 Article 84 European Commission Delegated Regulation (EU) No. 2015/35.

c risk exposure, concentration, mitigation and sensitivity for each category of risk;

d the bases and methods used for the valuation of assets, technical provisions, and other liabilities; and

e capital management, including (at least):
- the structure and amount of own funds, and their quality;
- the amounts of the SCR (including, subject to a transitional Member State option, any capital add-on) and the MCR;
- the option used for the calculation of the SCR;
- an explanation of the main differences between the underlying assumptions of the standard formula and the internal model used for the SCR calculation, where relevant; and
- the amount of any non-compliance with the MCR or any significant non-compliance with the SCR during the reporting period, and an explanation of the reasons for and impact of the non-compliance and any remedial measures taken.[118]

Insurers are required to demonstrate that the data are sufficiently complete, accurate and appropriately verified, and asset managers must ensure that the information they supply to insurance customers meets the same standards.[119]

VII THE CAPITAL REQUIREMENTS DIRECTIVES

i Background

In 2006, the Banking Consolidation Directive and the Capital Adequacy Directive (together referred to as the Capital Requirements Directive (CRD))[120] first imposed a minimum initial capital level that must be held by investment firms falling within MiFID, depending on the activities they undertake and the level of risk associated with such activities.[121] In addition, investment firms had to meet ongoing requirements to provide against risks for their trading-book businesses and their other business activities.[122] At the same time, the competent authority of each Member State was given supervisory powers and duties.

As part of the focus on reducing market risk after the financial crisis, the Commission introduced proposals to amend the text of the CRD, which culminated in the adoption and implementation of Directive 2009/111/EC (CRD II). This Directive aimed, *inter alia*, to clarify the application of limits on large exposures of firms subject to the CRD regime and

118 Article 51 Solvency II.

119 Op. cit. 105.

120 Directive 2006/48/EC and Directive 2006/49/EC together constitute the CRD. These directives required EEA Member States to implement the Basel II prudential standards. However, the CRD is wider in scope than Basel II, as it applies not only to internationally active banks, but also to investment firms subject to MiFID.

121 Chapter II, Directive 2006/49/EC. For example, investment firms falling under the definition in Article 3(1)(b)(iii) that are only authorised to provide investment advice, or receive and transmit orders from investors without holding client money or securities, have an initial capital requirement of €50,000 (Article 7), but firms dealing in financial instruments who do hold client money and securities (and which are therefore not firms referred to in Article 5 to Article 8) have an initial capital of €730,000 (Article 9).

122 Chapter V Directive 2006/49/EC.

to introduce new rules governing hybrid capital instruments qualifying as Tier 1 regulatory capital. CRD II came into force on 7 December 2009 and Member States were required to implement it by 31 December 2010.[123]

In the wake of CRD II, Directive 2010/76/EU (known as CRD III) was adopted on 11 October 2010, again in response to perceived regulatory failures that had been highlighted by the financial crisis. For example, CRD III addressed concerns that the remuneration policies prior to the financial crisis had incentivised risk-taking by financial institutions, including investment firms, and had undermined risk control. CRD III required firms to have remuneration policies that were consistent with, and promote effective risk management and imposed caps on, certain elements of the remuneration package. CRD III also aimed to address concerns that the models that were permitted under CRD to calculate capital requirements were flawed and did not require investment firms to maintain sufficient capital as a buffer against losses in their proprietary trading books. As a result, CRD III amended the capital requirements that apply in respect of the trading books of investment firms by introducing new capital charges depending on the risk models being used by individual firms.

CRD III was required to be implemented by Member States in stages, with the provisions relating to remuneration principles to have been transposed by 1 January 2011 and the revised rules relating to capital requirements to have been transposed by 31 December 2011.[124]

ii Current regime – CRD IV and the Capital Requirements Regulation[125]

To implement the Basel III rules made by the Basel Committee on Banking Supervision, on 20 July 2011 the Commission introduced proposals for a new directive, known as CRD IV,[126] and a new regulation, the Capital Requirements Regulation (CRR), which would replace the CRD.

CRD IV and the CRR were published in the Official Journal on 27 June 2013. Member States were required to transpose CRD IV into national law by 31 December 2013. The CRR is directly applicable and took effect from 1 January 2014. The timeline for full implementation largely depended on the timing of the delegated legislation related to enacting the net stable funding ratio (NSFR), which is now proposed as part of a package of further reforms to the CRD IV and CRR as proposed by the Commission in November 2016 (see below). Several pieces of delegated legislation have been published by the Commission since December 2013 supplementing CRD IV with regard to certain regulatory technical standards and implementing technical standards, and to the liquidity coverage ratio (LCR).

The CRD IV regime applies, broadly speaking, to investment firms which are subject to MiFID. However, firms that are not authorised to perform safekeeping and administration of financial instruments; provide only one or more of the investment services and activities listed in points 1 (Reception and transmission), 2 (Execution of orders), 4 (Portfolio management) and 5 (Investment advice) of Section A of Annex 1 MiFID; and are not permitted to hold client money or securities, fall outside of its scope. In practice, this provides an exemption for many asset management firms.

CRD IV makes investment firms subject to revised capital adequacy rules that require them to maintain a basic capital conservation buffer in addition to their basic minimum

123 Article 4 CRD II.

124 Article 3 CRD III.

125 Regulation (EU) No. 575/2013.

126 Directive 2013/36/EU.

regulatory capital requirement.[127] Firms may also, at the discretion of individual supervisory authorities, be required to maintain a counter-cyclical capital buffer in order to guard against losses that result from a sudden downturn following a period of economic growth.[128] If investment firms fail to maintain the required capital buffers, they are subject to restrictions on their ability to make distributions and a prohibition on the payment of variable remuneration where the obligation to pay was created at a time when the capital buffer requirements were not met.[129]

On 10 October 2014, the Commission adopted the Delegated Regulation,[130] which sets out detailed requirements for firms to hold sufficient unencumbered high-quality liquid assets as determined using the LCR. The Delegated Regulation was published in the Official Journal on 17 January 2015 and came into force on 6 February 2015. The LCR will be implemented over a period of four years, starting with a minimum ratio requirement of 60 per cent in October 2015, and gradually increasing to 100 per cent on 1 January 2018 unless the Commission delays full implementation until 1 January 2019.

In addition, CRD IV requires competent authorities to ensure that firms have policies and procedures in place to identify, manage and monitor the risk of excessive leverage.[131] Investment firms must address the risk of excessive leverage by taking account of potential reductions in their regulatory capital that may result from expected or realised losses, and should be able to withstand a range of potential stress events impacting regulatory capital.[132]

CRD IV also subjects firms to enhanced corporate governance requirements and a requirement to establish risk committees composed of non-executive members of their management bodies to advise the management on the risk profile of the firm and on its ongoing risk strategy.[133] In addition, CRD IV requires firms to disclose the number of individuals receiving remuneration of €1 million or more in each financial year.[134] CRD IV also implements a bonus cap under which variable remuneration cannot exceed fixed remuneration unless authorised by shareholders, in which case variable remuneration can be up to twice the fixed remuneration.[135]

With certain exceptions, CRD IV is a maximum harmonisation measure (meaning that there is little scope for national regimes to exceed the terms of the original EU legislation) that sets out the majority of the CRD's prudential high-level requirements for investment firms. As an EU regulation, the CRR is directly applicable in all Member States, and divergences in national rules will therefore be minimised. In contrast, provisions addressing the mechanics of prudential supervision are contained in the CRD IV Directive. As an EU directive, Member States have a small element of say on how they choose to implement the requirements. For example, while Member States are not be able to impose capital requirements in excess of the CRD IV levels (as these are provided for in the CRR), they have a degree of flexibility in relation to the calibration of capital buffers (which are set out in the CRD IV Directive).

127 Article 129 CRD IV.
128 Article 130 CRD IV.
129 Article 141(2)(b) CRD IV.
130 Regulation (EU) No. 575/2013.
131 Article 87 CRD IV.
132 Article 87(2) CRD IV.
133 Article 76(3) CRD IV.
134 Article 450 CRR.
135 Article 94(1) CRD.

iii Future outlook – CRD V and CRR II

In November 2016 the Commission published its proposals for amendments to CRD IV[136] and the CRR[137] (also referred to as the CRD V and CRR II), which are currently being considered by the Council and Parliament. These proposals include measures to ensure compliance with international standards and certain EU-specific reforms, including:

a a binding leverage ratio requirement of 3 per cent for all firms within the scope of CRD IV;

b a binding NSFR of at least 100 per cent on credit institutions and systemic investment firms;

c more risk-sensitive own funds requirements, including changes in respect of the calculation of own funds requirements for market risk, counterparty credit risk, large exposures, exposures to central counterparties and equity investments in collective investment undertakings (CIUs); and

d amendments to the Minimum Requirement for own funds and Eligible Liabilities to ensure that global systemically important institutions hold certain minimum levels of loss-absorbing capital and instruments in line with the total loss-absorbing capacity standards recommended by the Financial Stability Board.

The EBA recommended the introduction of the NSFR in December 2015. Now included as part of the CRD V reform proposals, the NSFR will sit alongside the LCR as a method to assess whether a firm has adequate stable funding to prevent liquidity mismatches. The NSFR is a ratio of an institution or firm's available stable funding to the amount of stable funding required by it over a one-year period, and an NSFR of 100 per cent would therefore require the relevant institution or firm to hold at all times sufficient stable funding to meet its funding needs. Stable funding is defined as those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year period under conditions of extended stress.

Regarding the own fund requirements under CRD V in respect of CIUs, the proposed amendments set out a more risk-sensitive approach to calculate own funds requirements for exposures to CIUs (which includes UCITS and AIFs). In addition to a standardised approach, CRD V incorporates a look-through and mandate approach that calculates own funds requirements based, respectively, on the underlying exposures or mandate of the relevant CIU.

VIII REGULATION ON SHORT SELLING AND CREDIT DEFAULT SWAPS

The European Regulation on short selling and certain aspects of credit default swaps (Short Selling Regulation)[138] was published in the Official Journal on 24 March 2012 and took effect on 1 November 2012. As an EU Regulation, it has direct effect in Member States and

136 The CRD V text can be found at: ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-854-F1-EN-MAIN.PDF.

137 The CRR II text can be found at: ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF.

138 Regulation (EU) No. 236/2012.

did not require any further transposition into national law. The Short Selling Regulation introduces measures to harmonise short-selling regimes across the EU for the first time. Significant provisions include:

a transparency – firms are required to disclose short positions relating to shares admitted to trading on a regulated market or multilateral trading facility and EU sovereign debt, taking into account positions in credit default swaps referencing an EU sovereign debt obligation;[139]

b restrictions on uncovered positions – a firm that wishes to take out an open position in shares needs to have borrowed the shares, entered into an agreement to borrow the shares or made other arrangements to ensure that settlement can be effected when due.[140] There are further restrictions on open positions in sovereign debt or through credit default swaps (where the positions are not hedged); and

c supervisory intervention – competent authorities in individual Member States may, in exceptional circumstances, take measures including further transparency requirements or temporary short-selling bans, while ESMA may intervene (i.e., by taking direct control of the regulation of short selling in an individual Member State and overruling the national regulator) if it considers there to be a significant threat (e.g., to the stability of the market).[141]

These requirements apply regardless of where the person effecting the short sale is domiciled. However, there is an exemption from the transparency requirements for shares whose principal trading venue (i.e., the regulated market or multilateral trading facility) is located outside the EU.

For fund managers managing several funds, the calculation of the net short position in a particular issuer is conducted at the level of each individual fund and for each portfolio under management. A discretionary manager should aggregate net short positions of funds and portfolios for which the same investment strategy is pursued in respect of a particular issuer. Where a single entity performs management and non-management activities (such as proprietary trading), it should conduct two separate calculations and, in some instances, may have to make two reports.

In July 2017, ESMA published a consultation paper on the evaluation of certain elements of the Short Selling Regulation, including the transparency requirements described above, and expects to provide its advice to the Commission by the end of 2017.[142]

IX THE ACQUISITIONS DIRECTIVE

The Acquisitions Directive,[143] also referred to as the Qualifying Holdings Directive, was formally adopted on 5 September 2007 and was to be implemented into the national law of Member States by 21 March 2009. The Acquisitions Directive intended to harmonise both the criteria that regulators apply in deciding whether to approve changes of control of financial

139 Articles 5, 6, and 7 Short Selling Regulation.

140 Chapter III Short Selling Regulation.

141 See Chapters V and VI Short Selling Regulation.

142 Available at www.esma.europa.eu/sites/default/files/library/esma70-145-127_consultation_paper_on_the_evaluation_of_certain_aspects_of_the_ssr.pdf.

143 Directive 2007/44/EC.

institutions (i.e., credit institutions, investment firms and insurers) and important aspects of the process by which they do so. The origin of the Directive lay in concerns that national interests and other factors inconsistent with the EU single market may have been affecting national regulators' decision-making processes. A committee comprising representatives of the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors and the CESR (referred to as the 3L3 Committee) published non-binding guidelines in December 2008 aimed at ensuring close cooperation between EU regulators when considering cross-border changes of control and promoting harmonisation of the processes involved.

The Acquisitions Directive is a maximum harmonisation directive, meaning that Member States may not gold plate the requirements and criteria set out in the Directive. The definition of control (at or above which the person holding such control requires regulator approval) is set at 10 per cent or more of share capital or voting rights, and the Acquisitions Directive also introduced a concept of aggregation of interests for the purposes of determining control where parties are acting in concert. The 3L3 Committee guidelines include some (albeit vague) guidance on the meaning of this expression in this context.

Between 8 December 2011 and 10 February 2012, the Commission consulted on the application of the Acquisitions Directive. The Commission published a report on 11 February 2013, concluding that the regime is working satisfactorily. However, the Commission asked the ESAs to clarify their Level 3 guidelines to provide more legal certainty and to ensure consistent application throughout the EU. In July 2015, the Joint Committee of the ESAs published a joint consultation paper on draft guidelines that were finalised in December 2016[144] and will apply from 1 October 2017. *Inter alia*, the guidelines seek to clarify the concept of indirect acquisitions of qualifying holdings and the definition of acting in concert.

X REFORM OF SHADOW BANKING

In March 2012, the Commission published a Green Paper[145] setting out its proposals for the reform of shadow banking. The Commission's message, articulated by Internal Market Commissioner Michel Barnier, is that, 'like all financial players, [firms carrying out shadow banking activities] must be covered by regulation'[146] to ensure that all activities that could affect financial stability are regulated, while at the same time opportunities for regulatory arbitrage are minimised.

However, there are substantial problems in defining precisely what shadow banking is and which organisations the reforms would cover. The Commission has adopted the Financial Stability Board's definition, which states that shadow banking comprises 'the system of credit intermediation that involves entities and activities outside the regular banking system'.[147] This encompasses organisations performing any of the following activities:

a utilising funding with deposit-like characteristics;

144 Available at https://esas-joint-committee.europa.eu/Pages/Guidelines/Joint-Guidelines-on-the-prudential-assessment-of-acquisitions-and-increases-of-qualifying-holdings-in-the-banking%2C-insuranc.aspx.

145 Available at ec.europa.eu/finance/general-policy/shadow-banking/index_en.htm.

146 Speech made by Michel Barnier at the press conference to accompany the publication of the Commission's Green Paper on Shadow Banking, 19 March 2012.

147 Available at www.financialstabilityboard.org.

b performing maturity or liquidity transformation, or both;
c undergoing credit risk transfer; and
d using direct or indirect financial leverage.

Clearly, this creates an extremely wide scope.

Asset management was one of the areas of focus for new measures in the Green Paper, with the Commission expressing concerns regarding possible liquidity mismatches in exchange traded funds, which heightens the risk of runs on MMFs, increases the fragility of the financial sector and augments the potential spillover effects of any failures.

On 4 September 2013, the Commission adopted a Communication on shadow banking and published a Proposal for a regulation on MMFs. The Communication outlines the five priorities on which the Commission intended to take action:
a the provision of a framework for MMFs;
b increasing the transparency of the shadow banking sector (e.g., through the collection and storing of trade data);
c reforming securities law;
d the provision of a framework governing the interactions of the shadow banking sector and banks; and
e improving the supervision of the shadow banking sector at EU and national levels.

The proposal for a regulation on MMFs required such funds to have a set proportion of their portfolio in highly liquid assets and sets limits on their exposures to a single issuer of securities. The proposal also introduced a capital buffer for fixed-net-asset-value MMFs; the proposal acknowledged this requirement may result in substantially increased management fees.

The MMF Regulation was published in the Official Journal on 30 June 2017 and will generally apply from 21 July 2018. It defines MMFs as CIUs that:
a require authorisation as UCITS or are authorised as UCITS under UCITS IV, or are an AIF under the AIFMD;
b invest in short-term assets; and
c have distinct or cumulative objectives offering returns in line with money market rates or preserving the value of the investment.[148]

The MMF Regulation also categorises MMFs, and includes provisions on, *inter alia*, eligibility criteria for assets in which MMFs can invest and diversification requirements. The proposed capital buffer for fixed-net-asset-value MMFs as originally proposed by the Commission has not been included in the final MMF Regulation.

In May 2017 ESMA published its consultation paper on certain Level 2 and Level 3 measures under the MMF Regulation,[149] with a view to finalise its technical advice, draft technical standards and guidelines by the end of 2017.

148 Article 1(1) MMF Regulation.

149 Available at www.esma.europa.eu/sites/default/files/library/esma-34-49-82_cp_on_draft_technical_advice_implementing_technical_standards_and_guidelines_under_the_mmf_regulation.pdf.

XI TAX LAW

In the absence of tax harmonisation, taxation remains a matter for the legislature of each Member State. With the exception of VAT and pending the outcome of current discussions on an EU-wide financial transactions tax, there is no centralised tax affecting asset management. The tax treatment of investors, funds and asset managers depends mainly on the laws of individual Member States.

Nevertheless, EU law materially qualifies the rights of Member States to levy taxes. It does so principally as a result of the application of the Treaty on the Functioning of the European Union (TFEU) and of directives adopted by the institutions of the EU. The TFEU and those directives have a direct bearing on the taxation of asset management within the EU, and each is considered in turn below.

i Application of the TFEU

Each of the four fundamental freedoms enshrined in the TFEU has direct effect, meaning that the right to it is granted to citizens and it can affect national tax rules directly (i.e., without the need for local implementation). Fundamental to these freedoms, and to the TFEU as a whole, is the principle of non-discrimination, which in the tax context typically prevents Member States from discriminating between citizens on the grounds of residence.

Of the four fundamental freedoms, the most relevant in the asset management tax context is the free movement of capital.[150] Given that movement of capital for these purposes includes operations in units of collective investment undertakings,[151] it is clear that tax legislation that restricts capital movement within the EU will have no effect (unless one of the key exceptions – which include the rights of Member States to distinguish between taxpayers who are not in the same position with regard to their place of residence or the place where their capital is invested[152] and to take all requisite measures needed to prevent infringements of their laws and regulations[153] – applies).

The TFEU's impact on dividend taxation is particularly significant in this regard. While Directive 2011/96/EU (as amended) on the taxation of parent companies and subsidiaries prevents the withholding of tax from the payment of qualifying dividends to corporate shareholders holding 10 per cent or more of the capital of the company, the payment of dividends to many non-corporates (especially individuals) is not subject to EU harmonisation of any sort. However, the TFEU's safeguarding of the free movement of capital means that a Member State may not tax inbound or outbound dividends more highly than domestic dividends. For example, in the 2009 case *Aberdeen Property Fininvest Alpha Oy*,[154] it was held that cross-border dividends paid to non-resident investment funds cannot be subject to withholding tax when dividends paid to comparable domestic parent companies and investment funds are exempt, and in *Santander Asset Management SGIIC SA v. Directeur des résidents à l'étranger et des services généraux*,[155] it was held that domestic and foreign UCITS are

150 Article 63 TFEU.

151 See Category IV of the list of capital movements in the Nomenclature of the Council Directive of 24 June 1988 for the implementation of Article 67 of the Treaty (Directive 88/361/EEC).

152 Article 65(1)(a) TFEU.

153 Article 65(1)(b) TFEU.

154 *Aberdeen Property Fininvest Alpha Oy* (C-303/07).

155 *Santander Asset Management SGIIC SA v. Directeur des résidents à l'étranger et des services généraux* (C-338/11).

comparable, such that they must be treated equally in relation to dividend taxation at source. That safeguarding may also restrict Member States from discriminating against non-EU investment funds – it was decided in *Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy* that it is contrary to the free movement of capital for Member States to withhold tax from dividends paid to investment funds established in third countries, but not dividends paid to investment funds established in EU Member States, if there is a mutual administrative assistance obligation between the Member State and the third country.[156]

ii Exchange of information

Of particular relevance to the direct taxation of asset management within the EU is the series of directives dealing with the exchange of information for tax purposes.

The first of these directives, the Savings Directive,[157] came into force on 1 July 2005. This aimed to ensure that cross-border payments of savings income were properly taxed in the recipient's state of residence, thereby eliminating distortions in capital movement between Member States. The legislation provided for two mechanisms to achieve this aim: (1) the exchange of information between Member States and (2) the withholding of tax at source. Since the introduction of the Savings Directive, the challenges posed by cross-border tax fraud and evasion and the development by the Organisation for Economic Co-operation and Development (OECD) of a new single global standard of automatic exchange of information – the Common Reporting Standard (CRS) – have resulted in significant changes to the legislative landscape.

The CRS was developed in response to a request from the G20 to the OECD in September 2013 and was approved by the OECD on 15 July 2014. It requires participating jurisdictions to obtain prescribed information from resident financial institutions and automatically exchange that information with other participating jurisdictions on an annual basis. It sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures.[158] As of August 2017, 101 jurisdictions were committed to the implementation of the CRS, with 50 jurisdictions committed to undertake their first exchanges of information under the regime in 2017 (including all Member States with the exception of Austria) and a further 51 jurisdictions committed to undertake their first exchanges in 2018.

To address the changing landscape, the Council has implemented further directives. Of particular note is the Directive on Administrative Cooperation (DAC), [159] which provides for the mandatory automatic exchange of certain information between Member States. On 9 December 2014, the European Council adopted Council Directive 2014/107/EU, which incorporated the CRS into DAC providing the CRS with a legal basis within the EU.

To avoid duplicative reporting and to save costs both for tax authorities and economic operators, the repeal of the Savings Directive was timed to coincide with the introduction

156 *Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy* (C-190/12).

157 Directive 2003/48/EC on the taxation of savings income in the form of interest payments.

158 OECD (2017), Standard for Automatic Exchange of Financial Account Information in Tax Matters, Second Edition, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264267992-en.

159 Directive 2011/16/EU.

of Directive 2014/107/EU on 1 January 2016, subject to certain transitional measures (and on 1 January 2017 in the case of Austria, which has a longer implementation period because of its historical arrangements pursuant to the Savings Directive differing from those of the other Member States). Notwithstanding the repeal of the Savings Directive, Member States are still required to fulfil their administrative obligations in relation to payments made before the date of repeal.

The Commission has agreed on the Amending Protocols to the Agreements between the EU and Switzerland, Monaco, Liechtenstein, Andorra and San Marino to reflect these changes in EU law (including the incorporation of the CRS).

iii Base erosion and profit shifting

Another area of relevance is the EU's response to the OECD's base erosion and profit shifting (BEPS) project. On 12 July 2016, the EU adopted Council Directive (EU) 2016/1164, known as the Anti-Tax Avoidance Directive (ATAD), to implement, at EU level, some of the OECD's BEPS recommendations. The ATAD sets out anti-avoidance measures in respect of certain areas including controlled foreign companies, exit taxation, interest deductibility and hybrids. It also introduces a general anti-abuse rule designed to counter aggressive tax planning structures. Member States have to implement all measures as of 1 January 2019, but there are longer periods for the exit taxation and interest deductibility provisions.

On 29 May 2017, the EU adopted Council Directive (EU) 2017/952, known as the ATAD II, which amends the ATAD, including its extension to cover hybrid mismatch arrangements between Member States and third countries (rather than only those between two Member States). Member States are required to implement the provisions of the ATAD II by 1 January 2020 (or, in the case of rules concerning reverse hybrid mismatches, 1 January 2022).

iv VAT

Directive 2006/112/EC on the common system of VAT (the VAT Directive) provides for the EU-wide harmonisation of the taxation of the supply by businesses of goods and services. It is the responsibility of each Member State to set the rate at which VAT will apply in that Member State.

The provision of supplies consisting of the management of assets is a supply of services that falls within the scope of VAT and is therefore potentially taxable, with the tax being borne by investors (although collected and paid by the supplier of that service, the investment manager).

Asset management in general is not exempt. There is, however, an important exemption for 'the management of special investment funds as defined by Member States'.[160]

Each Member State has discretion to define the scope of 'special investment fund', but only within the confines of the objective of the VAT Directive and the principle of fiscal neutrality. It has been held that the term is specific to the business of undertakings in collective investments[161] but that it cannot be defined to refer to portfolio management in general;[162] nor can it be defined in a way that distinguishes between open and closed-ended

160 Article 135(1)(g) VAT Directive.

161 *Abbey National plc and Inscape Investment Fund v. Commissioners of Customs and Excise* (C-169/04).

162 *Finanzamt Frankfurt am Main V-Höchst v. Deutsche Bank AG* (C-44/11).

funds.[163] It has also been held that it does not extend to defined benefit pension schemes or common investment funds pooling the assets of such schemes,[164] but that it may extend to certain defined contribution pension schemes, where the scheme members bear the investment risk.[165] The Court of Justice of the European Union (CJEU) held in *Fiscale Eenheid X NV*[166] that the exemption may extend to the management of real estate funds where the fund pools investments to spread risk, the risk is borne by the investors and the fund is subject to specific Member State supervision (i.e., regulation). It was held, however, that the exemption does not apply to the actual management of the immoveable property of the fund; it is limited to fund-specific functions, for example, investment recommendations and portfolio management.

The impact of the exemption is potentially significant for fund managers. Where it applies, the manager's ability to recover VAT incurred in the provision of management services to the fund will be restricted and its profit margin may be reduced as a result. Furthermore, pricing decisions reached on the assumption that the VAT exemption does not apply may be undermined if the CJEU subsequently decides that VAT was not payable. In such a scenario, the manager would lose its ability to recover input tax paid in respect of its costs in providing the management services. However, in such circumstances, the manager may be able to recover amounts that it had accounted for to the tax authority of the relevant Member State on the assumption that the services were taxable supplies (i.e., not exempt), subject to any conditions and limitations imposed by that Member State on claims for overpaid VAT. If the fund manager is successful in reclaiming VAT from the relevant tax authority, customers (i.e., the funds) may be able to claim against the fund manager for amounts that they had been wrongly charged in respect of VAT on the management services received. This was considered in a recent UK case, where the UK Supreme Court indicated that a fund manager's customers could potentially reclaim amounts paid in respect of VAT, but only to the extent that the fund manager had been 'unjustly enriched' by a repayment from HMRC.[167]

v Financial transaction tax

On 28 September 2011, the Commission presented a formal proposal for a financial transaction tax (FTT) in the (then) 27 Member States of the EU. Under the proposal, a tax would be levied at the rate of 0.1 per cent on the exchange of shares and bonds, and at the rate of 0.01 per cent on derivative contracts.

163 *JP Morgan Fleming Claverhouse Investment Trust plc v. The Commissioners of HM Revenue and Customs* (C-363/05).

164 *Wheels Common Investment Fund Trustees and Others v. Commissioners for Her Majesty's Revenue and Customs* (C-424/11). Note, however, that a pending appeal in the UK High Court seeks to challenge this view by reference to Article 135(1)(a) (rather than Article 135(1)(g)) of the VAT Directive. The trustee of the United Biscuits defined benefit pension fund is seeking to argue that, since similar fund management services are exempt under Article 135(1)(a) if supplied by an insurer, they should also be exempt when supplied by a non-insurer on the grounds of fiscal neutrality.

165 *ATP PensionService A/S v. Skatteministeriet* (C-464/12).

166 *Fiscale Eenheid X NV* (C-595/13).

167 *The Commissioners for Her Majesty's Revenue and Customs (Appellants) v. The Investment Trust Companies (in liquidation)* [2017] UKSC 29.

The proposal is currently supported by 10 Member States, which are participating in an enhanced cooperation process (originally 11 but Estonia left the process in March 2016), and has been approved by both the Parliament and the Council. However, as it is not unanimously supported it will, even if introduced, apply only to those supporting Member States.

Statements given by the supporting Member States in 2014 explained that they aim for the first step towards full implementation to take place by 1 January 2016. Little progress has been made since; most recently, Member States met at an Economic and Financial Affairs Council configuration meeting held on 17 June 2016, where it was reported that work would continue on the proposal during the second half of 2016 but that the result must be satisfactory to all Member States, not just the 10 Member States participating in the enhanced cooperation.

In January 2017, representatives of both the Commission and the Council indicated during a parliamentary debate that draft legislation relating to the FTT could be prepared by mid-2017. However, at the time of publication, no further details of such legislation have emerged.

vi State aid

Article 107 of the TFEU prohibits 'state aid' (i.e., measures taken by Member States to favour certain undertakings or certain industries in a way that could distort competition and affect trade between Member States). The state aid regime not only applies to the provision of positive benefits such as subsidies, but also to 'interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking'.[168] It can therefore apply to the tax practices of Member States. However, this will only be the case where a Member State is 'selective' in favour of a particular undertaking, category of undertakings or category of goods.

In recent years, the Commission has been more proactive in challenging the tax rulings of Member States, and high-profile investigations have been opened into arrangements between certain Member States and multinationals (e.g., Apple, Fiat, Santander and others). Indeed, in tax ruling cases involving multinationals, most of the state aid criteria are generally met: the ruling is issued by the state, it uses state resources (i.e., potential tax revenues) and it has the potential to distort competition and affect trade between Member States. The key question is whether the ruling grants a 'selective advantage' – one that is not available to other taxpayers in a comparable factual and legal situation. While none of the current investigations involve the asset management industry specifically, this is an area to watch closely, particularly as the Commission's scope for state aid investigations in the context of tax continues to expand.

168 *De Gezamenlijke Steenkolenmijnen in Limburg v. High Authority of the European Coal and Steel Community* (C-30/59).

NICK BONSALL

Slaughter and May

Nick Bonsall has been a partner in the financial regulation group at Slaughter and May in London since May 2016. He advises on the supervision and regulation of banks, asset managers, investment firms, payment institutions, insurance companies and building societies. Recently, his work has involved advising on various technical and transaction based matters in the asset management sector, including in relation to prudential requirements. He has also advised on financial services outsourcing, the UK electronic money and payment services regimes, and agreements for the distribution of retail investment products. He graduated from the University of Edinburgh with a degree in mathematics and statistics, and qualified as a solicitor in England and Wales in 2009.

SLAUGHTER AND MAY

One Bunhill Row
London
England EC1Y 8YY
United Kingdom
Tel: +44 20 7600 1200
Fax: +44 20 7090 5000
nick.bonsall@slaughterandmay.com
www.slaughterandmay.com

ABA Section of International Law
Your Gateway to International Practice

Strategic Research Sponsor of the
ABA Section of International Law

Law
Business
Research

ISBN 978-1-910813-82-9