The Asset Management Review

Ninth Edition

Editor
Paul Dickson

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The Asset Management Review

Ninth Edition

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PREFACE

What a difference a year makes! Last year we were reflecting on the uncertain global macroeconomic outlook brought about by geopolitical factors including political uncertainty and the rise of populist movements. In the UK and Europe, we were focusing on the uncertain future of the political and regulatory relationship with the EU. We had no idea that a more wide ranging event was soon to occur . . .

One imagines that 2020 will be primarily remembered in history as the year of the novel coronavirus pandemic, and all that the inescapable event has brought. The pandemic, far from being under control globally, is distracting from other developments and causing increased fear in the financial markets of the future strength of historically safe investments.

But what about those other events that the pandemic has masked? The UK has now left the EU and seems likely to fail to reach a 'deal' with EU on the long-term relationship at the end of the implementation period in 2021. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients.

Sources of global uncertainty for financial markets are on the rise, with only increasing tensions on the global political stage. There are multiple examples of foreign investment controls being tightened, sometimes for political reasons and sometimes for understandable economic ones.

Leaving all of of this aside though, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance (ESG) goals through private sector finance. For example, the European Commission has proposed a package of measures seeking to introduce sustainable finance into current regulations to make it easier for investors to identify and invest in such projects.

This should not be a surprise: lack of shareholder engagement has been identified as one of the key issues contributing to the governance shortcomings during the financial crisis. Given the importance of the asset management industry in investing vast amounts on behalf of clients, the sector is the natural focus of regulatory and governmental initiatives to promote effective stewardship and take the lead in instilling a corporate cultural focus on sustainability and ESG initiatives.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. Operational resilience – a concept

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focused on ensuring asset managers' holistic preparedness against any risk event, particularly significant operational risks – has become a significant focus point for global regulators.

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasingly being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or 'robo') advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies.

This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the ninth edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson
Slaughter and May
London
August 2020

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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.

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.

The UK left the EU on 31 January 2020, and the UK and the EU entered a transition period on that date that is due to end on 31 December 2020. During the transition period, the UK remains part of the EU Customs Union, EU law continues to apply in the UK, and references to terms such as 'EU' and 'Member State' in EU law are, unless otherwise stated, deemed to include references to the UK. References to 'EU' and 'Member State' in this chapter should, therefore, be read as including references to the UK for the duration of the transition period. At the time of writing, the UK and the EU are engaged in negotiations concerning the relationship between the UK and the EU following the end of the transition period. The nature of that relationship, and its potential impact on financial services trade between the UK and the EU is currently uncertain, and it remains uncertain how the UK's departure from the EU will affect any future EU legislative proposals. We do not, therefore, propose to comment on the likely nature of that relationship past the end of the Brexit transition period.

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1 Nick Bonsall is a partner at Slaughter and May. The author would like to thank Chris Hurn and Tanja Velling 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 Member States outside the EU are informed of legislative proposals, but they do not have a formal role in shaping policy.

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II EUROPEAN REGULATORY AND SUPERVISORY FRAMEWORK

i Key EU institutions

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

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

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

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 establish a new European Systemic Risk Board, responsible for macro-prudential oversight, and a European System of Financial Supervisors (ESFS), comprising three new pan-European Supervisory Authorities (ESAs) to replace the

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).

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Level 3 Committees: the European Banking Authority (EBA); the European Insurance and Occupational Pensions Authority (EIOPA); and 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.

Most notable of the three ESAs in this context is 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, 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).[4]

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 supervisory powers for ESMA with regard to certain capital markets segments, including data providers, pan-European investment fund schemes and post-trading market infrastructures.[5] Following responses to the consultation, in September 2017 the Commission published its legislative proposals in relation to the reform of the role and powers of the ESAs. On 12 September 2018, the Commission published a communication that introduced a proposal to concentrate anti-money laundering powers related to the financial sector into the EBA, including by way of strengthening the EBA's mandate to ensure effective and consistent supervision of the risks of money laundering by relevant EU authorities. On 21 March 2019, the Parliament and Member States reached a political agreement on a package of reforms to the supervision of EU financial services, including by way of strengthening the EBA's role in the area of anti-money laundering. On 16 April 2019, the Parliament endorsed at first reading legislation strengthening the powers of the ESAs, including in relation to the powers for the EBA that were proposed in the 21 March 2019 political agreement.[6] The proposal was adopted by the Council on 2 December 2019 and published in the OJ on 27 December 2019.[7]

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

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

6 Available at https://oeil.secure.europarl.europa.eu/oeil/popups/printsummary.pdf?id=1582113&l=en&t=E.

7 Regulation (EU) 2019/2175.

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III MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE REGIME

i Background

The Markets in Financial Instruments Directive (MiFID) regime 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 the first Markets in Financial Instruments Directive (MiFID I),[8] the provision of investment services within the EU was regulated by the Investment Services Directive (ISD).[9] 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.

On 20 October 2011, the Commission published a package of proposals for reform, including a draft directive that would repeal and recast MiFID I,[10] and a new, directly applicable regulation[11] (together referred to as MiFID II). In the explanatory memorandum, the Commission stated that while MiFID I had, 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 I regime was desirable to address the challenges posed by an increasingly complex financial landscape. In particular, one result of the liberalisation of markets under the MiFID I regime was that a great deal of trading of financial instruments now takes place away from regulated trading venues such as regulated markets and multilateral trading facilities (MTFs). In response to these developments, the Commission identified investor protection and trading transparency as broad areas that required reform and enhancement.

MiFID II entered into force on 12 June 2014 and, following a one-year delay because of challenges with implementation, became applicable in Member States on 3 January 2018. Various Level 2 measures (comprising binding regulatory technical standards and implementing technical standards), which are directly applicable in Member States, have also been introduced.

ii Scope of MiFID

The implementation of MiFID I had an important impact on investment firms across the EEA, expanding the scope of regulation of investment services. The MiFID regime applies to all EEA investment firms, which are defined as legal persons whose regular occupation or business is the provision of investment services to third parties, the performance of investment activities, or both, on a professional basis. The list of relevant investment services

8 Directive 2004/39/EC.
9 Directive 93/22/EEC.
10 Directive 2014/65/EU.
11 Regulation 600/2014.

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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 (CIUs) and various forms of derivatives. Under MiFID II, the scope of the MiFID regime was extended to, among other things, certain MiFID requirements to firms when selling or advising clients in relation to structured deposits.

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, CIUs 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) or the alternative investment funds (AIFs) regime (see Section V), will be exempt.[12]

The MiFID regime also contains a number of requirements (including the requirement to obtain authorisation) for market operators and investment firms that operate multilateral trading facilities (MTFs). MiFID II expanded this scope to include a new category of trading venue, organised trading facilities, which are trading venues other than regulated markets and MTFs in which multiple third-party buying and selling interests in non-equity interests are executed on a discretionary basis.

iii Conduct of business standards

MiFID I prescribed core business standards for firms providing investment services covering 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.

MiFID II has amended and enhanced the conduct of business standards in various areas, particularly in relation to investment advisory services and execution-only services. Under the new regime, investment firms providing investment advice are required to specify whether

12 In addition, entities that provide investment services solely for intra-group purposes do not fall within the scope of the MiFID regime; neither does any person who deals solely on his or her own account in financial instruments other than commodity derivatives or emission allowances or derivatives thereof, unless such persons are market makers; are members of or participants in a regulated market or MTF, on the one hand, or have direct electronic access to a trading venue, on the other, except for non-financial entities that execute transactions on a trading venue that are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of those non-financial entities or their groups; apply a high-frequency algorithmic trading technique; or deal on own account when executing client orders by virtue of Article 2(1)(d) MiFID II.

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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.[13] Advice is 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.[14]

In addition, under MiFID II, investment firms are required to specify how investment advice provided to a client meets the personal characteristics of that client.[15] MiFID II has also introduced provisions to regulate cross-selling practices where investment firms offer investment services together with other services as part of the same package – firms must now 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.[16]

The list of financial instruments that are considered to be non-complex for the purposes of the execution-only services exemption under MiFID has been 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 (ETFs) and other structured UCITS are no longer eligible for sale on an execution-only basis.[17]

MiFID II also introduced more extensive provisions dealing with corporate governance of investment firms, strengthening the existing rules under the 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). 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.

Other areas in which organisational and conduct of business rules have been enhanced include:

a the introduction of product governance requirements, under which firms that manufacture financial instruments for sale to clients must ensure that (among other things) the instruments are designed to meet the needs of an identified target market, the distribution strategy is compatible with that target market and the firm takes reasonable steps to ensure the financial instrument is distributed to the identified target market;[18]

b a requirement for firms to keep records of all services, activities and transactions it undertakes, which includes the obligation to record all relevant telephone conversations

13 Article 24(4) MiFID II.

14 Article 24(7) MiFID II.

15 Article 25(6) MiFID II.

16 Article 24(11) MiFID II.

17 Article 25(4)(a)(iv) MiFID II Directive. 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.

18 Article 24(2) MiFID II.

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and electronic communications relating to (at least) transactions concluded when dealing on own account, and providing services relating to reception and transmission and execution of client orders;[19] and

c significant reforms to the rules regarding payment and acceptance of inducements, including investment research (see subsection v below).

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.[20] A professional client 'possesses the experience, knowledge and expertise to make its own investment decisions and [to] properly assess the risks that it incurs'.[21] 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 (CISs) and their management companies.

In addition, large undertakings that satisfy two of the following criteria will also be considered professional clients: the balance sheet total for the entity is at least €20 million; the net turnover of the entity is at least €40 million; or 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.[22]

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 regulated financial institutions.[23] Certain obligations of investment firms are disapplied in respect of transactions involving eligible counterparties: for example, the duties to act in a client's best interest, assess the suitability and appropriateness of certain products before providing them to clients, and obtain the best possible result when executing client orders, and the obligation to execute a client's orders promptly, fairly and expeditiously, are excluded where the firm executes orders, deals on own account, or receives and transmits, orders with or for an eligible counterparty.[24] However, the duties of investment firms to eligible counterparties have been strengthened under MiFID II so that investment firms are now required to act honestly, fairly and professionally when dealing with such clients, and must communicate with them in a way that is fair, clear and not misleading.[25] In addition, investment firms are now required to provide the same appropriate information to eligible counterparties as is supplied to other

19 Article 16(6) and (7) MiFID II.
20 Set out in Annex II MiFID II.
21 Annex II preamble, MiFID II.
22 Section 2, Annex II MiFID II.
23 Article 30(2) MiFID II.
24 Article 30(1) MiFID II.
25 ibid.

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clients (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).[26]

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 Inducements

MiFID I contained certain requirements restricting the ability of firms to pay or receive fees, commission or non-monetary benefits to or from persons other than their clients (referred to as 'inducements'). Those requirements included that:

a the existence, nature and amount of the fee, commission or benefit (or, where the amount cannot be ascertained, the method of calculating it) must be clearly disclosed to the client in a comprehensive, accurate and understandable manner prior to the provision of the relevant financial instrument or financial service; and

b the payment must be 'designed to enhance the quality of the relevant service to the client' and not impair compliance with the firm's duty to act in the client's best interests.

MiFID II retains these provisions and expands on them, providing further guidance as to the circumstances in which an inducement shall be considered to be designed to enhance the quality of the relevant service.[27] The inducement must be justified by the provision of an additional or higher level service to the relevant client; proportional to the level of inducements received; not directly benefit the recipient firm, its shareholders or employees without tangible benefit to the relevant client; and be justified by the provision of an ongoing benefit to the relevant client in relation to an ongoing inducement.

The new regime also requires that the existence, nature and amount of the payment or benefit, or where the amount cannot be ascertained the method of calculating that amount, must be clearly disclosed to the client in a manner that is comprehensive, accurate and understandable prior to the provision of the relevant service. Where applicable, the investment firm must also inform the client of mechanisms for transferring the fee, commission, monetary or non-monetary benefit received to the client. MiFID II confirms that payments or benefits that enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and that by their nature cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients, are not subject to the above restrictions.[28]

More significant changes were introduced by MiFID II for firms providing independent advice and portfolio management services. Such firms are prohibited from accepting third-party inducements unless those inducements constitute 'minor non-monetary benefits'.[29] The MiFID II Delegated Directive contains an exhaustive list of those benefits that will qualify as acceptable minor non-monetary benefits. These include, among other

26 ibid.
27 Article 11(2) Commission Delegated Directive (EU) 2017/593 (MiFID II Delegated Directive).
28 Article 24(9) MiFID II.
29 Article 24(7) and (8) MiFID II.

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things, information or documentation relating to a financial instrument or an investment service that is generic in nature or personalised to reflect the circumstances of an individual client, hospitality of a reasonable *de minimis* value, and other minor non-monetary benefits that a Member State has deemed capable of enhancing the quality of service provided to a client.[30]

A further area of reform that has attracted much attention from commentators and the financial media concerns the treatment of investment research. MiFID II confirms that investment research will constitute an inducement unless it is received in return for: direct payments from the investment firm out of its own resources; or payments from a separate research payment account controlled by the investment firm, provided certain conditions are met. These include that:

a the research payment account is funded by a specific research charge to the client;
b as part of establishing a research payment account and agreeing the research charge with their clients, investment firms set and regularly assess a research budget as an internal administrative measure;
c the investment firm is held responsible for the research payment account; and
d the investment firm regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.

On 24 July 2020, the Commission published a proposal to amend MiIFD II to introduce a narrowly defined exception authorising the joint payment for execution services and research on small and mid-cap issuers and research on fixed income instruments (i.e., rolling back the prohibition on bundling research and other services for those issuers). For the purposes, small and mid-cap companies would be defined as companies that did not exceed a market capitalisation threshold of €1 billion over a 12-month period. The legislative proposal is open for consultation until 4 September 2020, after which it is anticipated that the proposal will be adopted and published in the OJ.

vi Third-country branches

In the context of asset management, a significant change introduced by Chapter IV of MiFID II relates to the provision of MiFID-regulated investment services by third-country (i.e., non-EEA) firms. Previously, such third-country firms were subject to national regimes in force in each Member State. MiFID II harmonises the approach to be taken in this regard (subject to transitional arrangements in the Markets in Financial Instruments Regulation (MiFIR), allowing 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).[31] In place of the national regimes, two new MiFID passports, for branches and cross-border services respectively, are offered to third-country firms. The criteria for the granting of these passports are set out below.

30 Article 12(3) MiFID II Delegated Directive.
31 Article 54 MiFIR.

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A third-country firm wishing to provide services to retail clients anywhere in the EU is now required to establish a branch (i.e., a physical establishment) somewhere in the EU.[32] MiFID II only permits the establishment of such a branch if certain specified conditions are met,[33] 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 sufficient initial capital is at the free disposal of the branch;

d 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

e the third-country firm belongs to an investor-compensation scheme authorised or recognised in accordance with the Directive on investor compensation schemes.[34]

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 the new MiFID II regime, in this context, is that it places 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 are likely to be somewhat protectionist, potentially 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. However, the extent of the effect of these new provisions on market practice remains to be seen.

IV THE UCITS REGIME

i Background

The first UCITS Directive (UCITS I)[35] 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.

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[36] that were not available to managers of

32 Article 39(1) MiFID II.

33 Article 39(2) MiFID II.

34 Directive 97/9/EC.

35 Council Directive 85/611/EEC.

36 Council Directive 93/22/EEC.

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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[37] and the Management Company Directive,[38] 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[39] (as amended by UCITS V)[40]

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.[41]

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. In particular, the Commission outlined its concern, in the wake of events connected with the Lehman Brothers bankruptcy and the Madoff scandal,[42] 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

37 Council Directive 2001/108/EC.

38 Council Directive 2001/107/EC.

39 Directive 2009/65/EC.

40 Directive 2014/91/EU.

41 ESMA opinion, Practical arrangements for the late transposition of the UCITS IV Directive, 13 October 2011.

42 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 CISs. 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

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uneven patchwork for investors across the EU. In the UCITS V Proposal, the Commission also argued that the evolution of market practice and the investment environment within the EU had led to an increasing use of sub-custody arrangements, which may have entailed significant risk for funds as it remained unclear the extent to which a depositary was liable for sub-custodian losses. The Commission also referred to divergences as between national regulatory regimes and weaknesses that it believed were undermining the supervision of financial services within the EU, with the result that the Commission sought to introduce proposals to set common minimum standards on issues such as the appointment and the duties of depositaries.

The UCITS V Directive was published in the Official Journal of the EU (the OJ) 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.[43]

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.[44]

iv Authorisation of a UCITS

The UCITS regime requires that a UCITS fund 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.[45] Once the UCITS has been authorised by the home state, that authorisation is valid across all Member States of the EU.

A particular irritation for some in the sector has historically been that some Member States have taken a very long time to process applications, whether for new funds or to register overseas funds. In response to this, UCITS IV provided 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 time limit was not amended by the UCITS V regime. The fact that this time limit applies 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.

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.

43 Article 1(2) UCITS IV.

44 Article 3(d) UCITS IV.

45 Article 5 UCITS IV.

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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,[46] or that have been admitted to official listing on a stock exchange or are dealt with on another regulated market in a third country;[47]

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,[48] and they are admitted within a year of issue;

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

d units of other CISs 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' 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).

The investments eligible for UCITS investment have frequently been interpreted differently in Member States, and this has been a cause of uncertainty, so much so that the Eligible Assets Directive[49] was introduced in 2007 in an attempt to improve consistency in relation to eligible and ineligible investments.

In addition to prescribing eligible investments, the UCITS regime includes rules on concentrations of investments so that all UCITS meet a minimum level of investment diversification. Those rules, which are relatively complex, include that:

a a UCITS may invest no more than 5 per cent of its assets in transferable securities or money market instruments issued by any single body, or 20 per cent of its assets in deposits made with the same body;

46 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.

47 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).

48 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).

49 Directive 2007/16/EC.

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b a UCITS may invest no more than:
- 20 per cent of its assets in transferable securities and money market instruments issued by entities belonging to the same group;
- 20 per cent of its assets in a single body; or
- 10 per cent of its assets in the units of a single UCITS or other collective investment undertaking, provided that Member States may raise this limit to a maximum of 20 per cent;

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); and

d subject to the right of Member States to waive the following requirements, a UCITS may acquire no more than:
- 10 per cent of the non-voting shares of a single issuing body;
- 10 per cent of the debt securities of a single issuing body;
- 25 per cent of the units of a single UCITS or other collective investment undertaking; or
- 10 per cent of the money market instruments of a single issuing body.

Member States may raise the 5 per cent limit referred to in (a) above:

a to a maximum of 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' assets);

b to a maximum of 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,[50] provided that Member States may derogate from this limit 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; or

c insofar as it relates to bonds issued by a credit institution that has its registered office in a Member State and that is subject to public legal supervision designed to protect its bondholders, up to 25 per cent of its assets in such bonds. However, if more than 5 per cent of the UCITS' 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.[51]

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 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

50 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.

51 Article 52(4) UCITS IV.

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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.[52]

Management companies may only carry out a limited range of activities, which consist principally of management of UCITS and other CISs (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 CISs.[53]

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);[54]

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;[55]

c the head office and the registered office of the management company must be located in the same Member State;[56]

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;[57]

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;[58] and

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.[59]

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

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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;[60]

b observe prudential rules drawn up by the Member State in which the management company has been authorised;[61]

c have sound administrative and accounting procedures;[62]

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;[63] 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.[64]

The UCITS regime also requires management companies to establish and apply remuneration policies and practices that are consistent with, and promote, sound and effective risk management, and that neither encourage risk taking that is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS that they manage, nor impair compliance with the management company's duty to act in the best interest of the UCITS.[65]

UCITS IV sets out principles that UCITS management companies must comply with when establishing and applying their remuneration policies, and these principles remain unchanged by UCITS V. For example, UCITS management companies must have remuneration policies that promote sound and effective risk management, and that do not encourage risk-taking or impair a management company's duty to act in the best interests of the UCITS.[66] 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.[67] 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[68] 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.[69]

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

60 Article 10(1) UCITS IV.

61 Article 12(1) UCITS IV.

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

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

64 Article 15 UCITS IV.

65 Article 14a UCITS IV.

66 Article 14a UCITS IV.

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

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

69 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.pdf.

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a Member State other than the UCITS' home Member State,[70] while management companies are also permitted to establish branches in other Member States subject to compliance with certain notification requirements.[71]

vii UCITS depositaries

UCITS must entrust the safe custody of their assets to a depositary for safekeeping.[72] 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 the 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;
e income is applied in accordance with applicable national laws and the fund's constitution and rules;
f the cash flows of the UCITS are properly monitored and, in particular, that all payments made by, or on behalf of, investors upon the subscription of units of the UCITS have been received, and that all cash of the UCITS has been booked in cash accounts that must meet certain specified conditions;
g ensure the safekeeping of the UCITS' assets;
h on a regular basis, provide the management company of the investment company of the UCITS with a comprehensive inventory of the UCITS' assets; and
i subject to limited exceptions, ensure that the UCITS' assets are not reused by the depositary, or any third party to which custody function has been delegated, for their own account.

The depositary must have its registered office or must be established in the home state of the UCITS.[73] The depositary must also be a national central bank, a credit institution authorised under the CRD IV Directive[74] or an entity authorised by a 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.

70 Article 16(3) UCITS IV.
71 Article 17 UCITS IV.
72 Articles 22 UCITS IV.
73 Article 23(1) UCITS IV.
74 Directive 2013/36/EU.

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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.[75]

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 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)[76] (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 the 2016 Delegated Regulation[77] setting out the detailed Level 2 measures that relate to depositaries. The 2016 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.

On 12 July 2018, the Commission adopted the 2018 Delegated Regulation,[78] further specifying depositaries' duties with regard to the safe-keeping of UCITS' assets under Article 22a(3)(c) of UCITS IV, a topic addressed by the 2016 Delegated Regulation. That provision of UCITS IV requires that where a depositary delegates safe-keeping functions to third parties (custodians), the assets also need to be segregated at the level of the delegate. The 2018 Delegated Regulation seeks to restrict the scope for divergent national applications of Article 22a(3)(c) of UCITS IV, identified by ESMA in an opinion on asset segregation.[79] The 2018 Delegated Regulation entered into force on 20 November 2018, and will apply from 1 April 2020.

75 Article 25 UCITS IV.

76 Directive 2011/61/EU.

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

78 Commission Delegated Regulation (EU) No. 2018/1619.

79 Opinion of ESMA, 20.07.2017, 34-45-277.

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It is clear that, as a result of the changes introduced by UCITS V and those introduced by the 2016 Delegated Regulation and the 2018 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, and again, the UCITS V regime does not amend these rules. There are three different methods of merging UCITS:

a 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.[80]

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 the terms of the proposed merger.[81] The competent authorities of the merging UCITS' home Member State will then forward that information to the competent authorities of the other UCITS' home Member State, which 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

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

81 Article 39(2) UCITS IV. Under Article 39(5), if the competent authorities of the merging UCITS' 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.

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meeting.[82] 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 feeder UCITS. These are UCITS that, by way of exception to the general rules preventing concentrations of investment by UCITS, are permitted to invest up to 85 per cent of their assets in another UCITS (a master UCITS).[83] The 15 per cent balance may be held in ancillary liquid assets, derivatives used only for hedging purposes or property that is essential for the direct pursuit of the business.[84] 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.[85]

Before a feeder UCITS can invest in a master UCITS, it must obtain the approval of the competent authorities of the feeder UCITS' home state.[86] 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.[87]

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.[88] Where the master and feeder UCITS use different depositaries, those depositaries must also enter into an agreement to share information to allow both depositaries to fulfil their duties under UCITS IV.[89]

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

82 Article 44 UCITS IV.
83 Article 58(1) UCITS IV.
84 Article 58(2) UCITS IV.
85 Article 58(3) UCITS IV.
86 Article 59(1) UCITS IV.
87 Article 59(3) UCITS IV.
88 Commission Directive 2010/42/EU.
89 Article 61 UCITS IV.

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depending on their respective Member State. It is expected that they will be an increasing feature of investment fund structures unless and until a full harmonisation of personal and institutional taxation takes place (which is currently 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.[90]

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.[91] 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.[92]

The annual report of a UCITS must include:

a a balance sheet or a statement of assets and liabilities;

b an income and expenditure account for the relevant financial year;

c a report on its activities during the financial year; and

d 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' past performance or performance scenarios;

d the UCITS' 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.[93]

UCITS V introduced requirements that the key investor information also:

90 Article 68 UCITS IV.

91 Article 69(1) UCITS IV.

92 Article 70(1) UCITS IV.

93 Article 78(3) UCITS IV.

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a clearly specifies where and how to obtain additional information relating to the proposed investment, including but not limited to where and how the prospectus and the annual and half-yearly reports can be obtained on request and free of charge at any time, and the language in which such information is available to investors; and

b includes a statement of the details of the up-to-date remuneration policy including, but not limited to, the following:
- a description of how remuneration and benefits are calculated;
- the identities of persons responsible for awarding the remuneration and benefits, including the composition of the remuneration committee (where such a remuneration committee exists): these must be made available by means of a website; and

c a reference to that website, and the fact that a paper copy will be made available free of charge upon request.

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 and drawn up in a common format to allow for easy comparison by investors.[94] To encourage consistency, ESMA provides a template on its website that may be used as the basis of a key investor information document (KIID).[95]

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 and UCITS V set 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.[96]

94 Article 78(5) UCITS IV.

95 www.esma.europa.eu/content/CESR%E2%80%99s-template-Key-Investor-Information-document.

96 Article 99(6) UCITS IV.

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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 received responses to the consultation, but did not publish a legislative proposal. No legislative proposal on UCITS VI is anticipated in the short term. Indeed, in a speech in November 2014,[97] Steven Maijoor, the Chair of ESMA, stated that many of the pressing issues that might have called for the introduction of UCITS VI were being dealt with in other initiatives such as the introduction of an MMF Regulation (see Section X) and issues relating to securities lending, repo and reverse repo activity, which had been addressed through guidelines originally issued by ESMA in December 2012 on ETFs and other UCITS issues.[98] Similarly, a Regulation on European long-term investment funds (ELTIFs) was introduced to establish a new type of collective investment vehicle that allows investors to make long-term investments (i.e., 'patient capital') in companies and projects (see Section XIII).

On 16 April 2019, the Parliament adopted a Directive and a Regulation on the cross-border distribution of collective investment funds that contain new provisions intended to harmonise the rules governing the marketing of investment funds across the EU, and amends the UCITS Directive and the AIFMD (the Cross-border Funds Marketing Directive[99] and the Cross-Border Funds Marketing Regulation[100] respectively). The Directive and the Regulation were published in the OJ on 12 July 2019, and entered into force on 1 August 2019. Member States are required to transpose the provisions of that Directive within 24 months of it coming into force. The Directive introduces obligations on UCITS management companies to provide local facilities to support investors (for instance, facilities

97 Available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1333_steven_maijoor_keynote_speech_at_efama_5_nov_2014.pdf.

98 ESMA Guidelines for competent authorities and UCITS management companies: Guidelines on ETFs and other UCITS issues (01/08/2014 | ESMA/2014/937EN); available at https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf.

99 Directive (EU) 2019/1160.

100 Regulation (EU) 2019/1156.

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to process subscriptions, repurchase and redemption orders, and to make other payments to unit-holders relating to the units of the UCITS). UCITS management companies will also be required to send a written notification containing certain prescribed information to the competent authorities of its home Member State if it wishes to market a UCITS in another Member State. The Directive will also provide for the 'denotification' of UCITS, subject to certain conditions being met, where the management company determines that it no longer wishes to market a UCITS in a Member State. The Regulation provides for certain additional rules relating to marketing communications to investors.

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 target companies of leveraged buyouts in which a 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.

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 and the UK are managed from London, which is also responsible for a significant portion of other non-UCITS investment funds marketed or managed in the EU and the UK. 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 CIS that is not covered by the UCITS regime.[101] 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

101 Article 4(1)(a) and (b) AIFMD.

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established) within the EU.[102] 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.[103]

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 risks and conduct regular stress tests;
e AIFMs will be required to set a maximum level of leverage for each AIF;
f extensive requirements in relation to the valuation of managed assets, delegation of the AIFM's functions and the use of a depositary to safeguard an AIF's assets;
g 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 a requirement to produce annual reports, and to make disclosures to investors and regulators on an ongoing basis;
i restrictions on asset stripping; and
j 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.[104]

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.

102 Article 2(1) and (2) AIFMD.

103 Articles 2 and 3 AIFMD.

104 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. This extremely important concession continues to 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. 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 Commission has so far not acted upon the final advice provided by ESMA, and in the meantime national private placement regimes 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.

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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[105] 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.[106]

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.[107] 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.[108]

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[109] and the other to establish the procedure for AIFMs to opt in under the AIFMD.[110]

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.[111] 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. ESMA has also published guidelines on key concepts of the AIFMD[112] that give guidance on

105 European Commission Delegated Regulation (EU) No. 231/2013.
106 See a Council statement of February 2013, available at register.consilium.europa.eu/pdf/en/13/st06/st06687-ad01.en13.pdf.
107 Available at ec.europa.eu/internal_market/investment/docs/alternative_investments/131217_delegated-regulation_en.pdf.
108 Available at eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0514&from=EN.
109 Commission Implementing Regulation (EU) No. 448/2013.
110 Commission Implementing Regulation (EU) No. 447/2013.
111 Available at www.esma.europa.eu/system/files/2013-201.pdf.
112 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.pdf.

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the definition of an AIF,[113] Q&As on the application of AIFMD,[114] and guidelines[115] on reporting obligations under the AIFMD that set out the information AIFMs should report to regulators and the times when reports must be made.

On 7 April 2017, ESMA published the findings of its thematic study on notification frameworks and home host responsibilities under the AIFMD and the UCITS Directive.[116] ESMA subsequently produced opinions regarding the delegation model on 17 and 20 July 2017.[117] For further detail on the impact of ESMA's actions in light of Brexit, see the United Kingdom chapter.

The reforms to the rules on marketing to investors that have been introduced by the Cross-Border Funds Marketing Regulation also apply in respect of the marketing by AIFMs or AIFs.

In addition, on 30 October 2018 a delegated regulation to amend the AIFMD Level 2 Regulation as regards safe-keeping duties of depositaries was published in the OJ. That Regulation entered into force on 19 November 2018.[118] Although securities and insolvency laws are not harmonised across the EU, the delegated regulation attempts to harmonise rules on safe-keeping of AIF assets by ensuring the clear identification of those assets when they are held by a third-party custodian. The delegated regulation will apply from 1 April 2020.

In accordance with its obligations under Article 69 of the AIFMD, on 10 December 2018, the Commission published a report on the application and scope of the AIFMD.[119] The report set out the Commission's view that the AIFMD had 'played a major role in helping to create an internal market for AIFs and a harmonised and stringent regulatory and supervisory framework for AIFMs'.[120] The report identified certain areas of the application of the AIFMD for further consideration, including, among others, inadequate and duplicative reporting requirements, particularly when other EU reporting requirements are taken into account, and a lack of transparency in relation to the application of the marketing passport due to Member States taking different approaches to interpreting the meaning of 'marketing' for the purposes of the AIFMD.

In relation to the AIFMD, the Cross-border Funds Marketing Directive aims to clarify the scope of 'pre-marketing' activities that an EU AIFM may engage in without making a prior notification to the competent authority in its home Member State, and introduces a notification procedure for AIFMs that wish to discontinue marketing activities in a Member State.

113 Article 4(1)(a) AIFMD.

114 ESMA, Questions and Answers – Application of the AIFMD, 5 October 2017.

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

116 ESMA, Notification frameworks and home-host responsibilities under UCITS and AIFMD – Thematic Study among National Competent Authorities, 7 April 2017.

117 ESMA, Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, 13 July 2017; and ESMA, Opinion - Asset segregation and application of depositary delegation rules to CSDs, 20 July 2017.

118 Delegated Regulation (EU) 2018/1618 amending Delegated Regulation (EU) 231/2013 as regards safe-keeping duties of depositaries; available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1618&from=EN.

119 Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU (FISMA/2016/105(02)/C); available at https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190110-aifmd-operation-report_en.pdf.

120 ibid, page 4.

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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)[121] came into force on 1 January 2016, and introduced a new, harmonised EU-wide insurance regulatory regime, replacing various EU insurance directives including the Recast Life Directive.[122] 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 18 January 2015.[123] EIOPA 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.[124] Solvency II has been subject to subsequent amendments.[125]

The Commission proposals reforming the ESFS, mentioned in Section II.v, will also amend Solvency II, giving EIOPA a greater role in contributing to supervisory convergence.[126] On 5 April 2018, the Commission published a report discussing concerns and issues surrounding the implementation of Solvency II.[127] It discusses EIOPA's concerns[128] with regards to group supervision, including the definition of group supervision.

121 Directive 2009/138/EC.

122 Directive 2002/83/EC.

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

124 Article 4 Solvency II.

125 For example, amendments in line with the Securitisation Regulation (EU) 2017/2402.

126 European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/65/EU on markets in financial instruments and Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

127 European Commission, Report from the Commission to the European Parliament and the Council on the application of Title III of Directive 2009/138/EC of the European Parliament and the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) as regards the supervision of insurance and reinsurance undertakings in a group, and the assessment of the transitional period for the occupational retirement provision business of life insurance undertakings, 5 April 2018.

128 Reflected in EIOPA, Report to the European Commission on the Application of Group Supervision under the Solvency II Directive, 22 December 2017.

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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.[129] 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.[130] The basic solvency capital requirement consists of various risk modules, including to cover underwriting risk, market risk and counterparty default risk.[131] 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 EIOPA 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.

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;

129 See Section 2, Chapter VI Solvency II.

130 Article 103 Solvency II.

131 Article 104 Solvency II.

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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 a 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.[132]

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.[133] 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.[134]

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.[135] 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;

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

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

132 Article 132 Solvency II.

133 Article 132(4) Solvency II.

134 Article 133(3) Solvency II.

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

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- 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.[136]

Insurers are required to demonstrate that the data is sufficiently complete, accurate and appropriately verified, and asset managers must ensure that the information they supply to insurance customers meets the same standards.[137]

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))[138] 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.[139] In addition, investment firms had to meet ongoing requirements to provide against risks for their trading-book businesses and their other business activities.[140] 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, among other things, to clarify the application of limits on large exposures of firms subject to the CRD regime and 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.[141]

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

136 Article 51 Solvency II.

137 Article 105 Solvency II.

138 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.

139 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).

140 Chapter V Directive 2006/49/EC.

141 Article 4 CRD II.

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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.[142]

ii CRD IV and the Capital Requirements Regulation[143]

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,[144] and a new regulation, the Capital Requirements Regulation (CRR), which would replace the CRD.

CRD IV and the CRR were published in the OJ 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 that are subject to MiFID. However, the following fall outside of its scope:

a firms that are not authorised to perform safekeeping and administration of financial instruments;

b firms that 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 firms that are not permitted to hold client money or securities.

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 regulatory capital requirement.[145] Firms may also, at the discretion of individual supervisory authorities, be required to maintain a counter-cyclical capital buffer to guard against losses that result from a sudden downturn following a period of economic growth.[146] If investment firms fail to maintain the required capital buffers, they are subject to restrictions on their

142 Article 3 CRD III.

143 Regulation (EU) No. 575/2013.

144 Directive 2013/36/EU.

145 Article 129 CRD IV.

146 Article 130 CRD IV.

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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.[147]

On 10 October 2014, the Commission adopted the Delegated Regulation,[148] 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 OJ 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.

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.[149] 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.[150]

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 management on the risk profile of a firm and on its ongoing risk strategy.[151] In addition, CRD IV requires firms to disclose the number of individuals receiving remuneration of €1 million or more in each financial year.[152] 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.[153]

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 in 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).

147 Article 141(2)(b) CRD IV.
148 Regulation (EU) No. 575/2013.
149 Article 87 CRD IV.
150 Article 87(2) CRD IV.
151 Article 76(3) CRD IV.
152 Article 450 CRR.
153 Article 94(1) CRD.

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iii The Current regime

CRD V and CRR II

In November 2016, the Commission published its proposals for amendments to CRD IV and the CRR (also referred to as CRD V and CRR II). On 7 June 2019, CRD IV[154] and CRR II[155] were published in the OJ. They entered into force on 27 June 2019. For the most part, CRR II will apply from 28 June 2021, and Member States were required to implement and apply CRD V by 28 December 2019. CRD IV and CRR II 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 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 reforms, 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 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.

154 Directive (EU) 2019/878 amending the CRD IV Directive (2013/36/EU) as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.

155 Regulation (EU) 2019/876 amending the Capital Requirements Regulation (575/2013) as regards the leverage ratio, the net stable funding ratio (NSFR), requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties (CCPs), exposures to collective investment undertakings, large exposures, reporting and disclosure requirements.

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Revised prudential framework for investment firms

In December 2017, the Commission adopted proposals for a Regulation (the IFR) on the prudential requirements on investment firms and a Directive (the IFD) on the prudential supervision of investment firms.[156] On 5 December 2019, the IFD[157] and the IFR[158] were published in the OJ. The IFR will apply from, and Member States will be required to implement the IFD by, 26 June 2021.

This framework will replace the existing prudential requirements set out in the CRR for most investment firms authorised under MiFID. The aim is to simplify the prudential classification of investment firms and establish a single harmonised approach to their prudential requirements. It also seeks to increase proportionality and risk-sensitivity and reduce the complexity of the existing system. It is not intended to increase capital requirements significantly beyond the current level.

Under the revised prudential framework:

a certain systemically important firms will be reclassified as credit institutions, and will remain subject to the existing regime under the CRR and CRD IV. If these firms are established in Member States participating in the banking union, they will come within the scope of the single supervisory mechanism;

b all other investment firms will be subject to the new prudential framework, replacing the requirements set out in the CRR and the CRD IV Directive. Certain small and non-interconnected investment firms will be subject to a more limited prudential regime;

c quantitative indicators, referred to as 'K-factors', which are intended to represent various risks to which the firm is exposed, will be used to classify investment firms and determine the capital requirements methodology to which they will be subject. The K-factors include 'risk-to-customer' factors, 'risk-to-market' factors, and 'risk-to-firm' factors; and

d investment firms will be subject to revised remuneration and governance standards.

The new prudential framework is also intended to tighten requirements relating to equivalence decisions taken in relation to third countries and the supervision of firms with parent undertakings in third countries. Where a firm has its parent undertaking in a third country, if the relevant EU supervisory authority considers that the firm is not subject to supervision by the third country that is equivalent to the supervision under this new prudential framework, it may require the establishment of an investment holding company or mixed financial holding company in the EU.

VIII REGULATION ON SHORT SELLING AND CREDIT DEFAULT SWAPS

The European Regulation on short selling and certain aspects of credit default swaps (the Short Selling Regulation)[159] was published in the OJ on 24 March 2012 and took effect on 1 November 2012. As an EU regulation, it has direct effect in Member States and did not

156 Procedure files COM(2017) 790 final and COM(2017) 791 final.

157 Directive (EU) 2019/2034.

158 Regulation (EU) 2019/2033.

159 Regulation (EU) No. 236/2012.

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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 MTF and EU sovereign debt, taking into account positions in credit default swaps referencing an EU sovereign debt obligation;[160]

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.[161] 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).[162]

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 MTF) 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.

On 7 July 2017, ESMA published a consultation paper on the evaluation of certain elements of the Short Selling Regulation, including the transparency requirements described above. On 21 December 2017, ESMA published its final report on its evaluation of those matters.[163] ESMA's 2019 annual work programme stated that ESMA may revise and expand its technical advice during the course of 2019. However, ESMA's annual work programme for 2020 merely states that ESMA will continue with its Q&As, advice and supervisory briefings on the SSR; there is no reference to expanding its 2017 technical advice.

160 Articles 5, 6 and 7 Short Selling Regulation.

161 Chapter III Short Selling Regulation.

162 See Chapters V and VI Short Selling Regulation.

163 Final Report: Technical Advice on the evaluation of certain elements of the Short Selling Regulation (ESMA70-145-386).

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IX THE QUALIFIYING HOLDINGS REGIME

The 'qualifying holdings regime' comprises certain requirements imposed across various pieces of EU financial services sectoral legislation, particularly MiFID II, Solvency II and CRD IV. That regime has its origins in the Acquisitions Directive,[164] also referred to as the 'Qualifying Holdings Directive', which 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 was repealed and replaced (in part) by MiFID II.

The qualifying holdings regime sets out harmonised criteria that regulators apply in deciding whether to approve changes of control of financial institutions (i.e., credit institutions, investment firms and insurers), and important aspects of the process by which they do so. Similar requirements apply in respect of qualifying holdings in management companies under the UCITS Directive and AIFMD.

X REFORM OF SHADOW BANKING

In March 2012, the Commission published a Green Paper[165] 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'[166] 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'.[167] This encompasses organisations performing any of the following activities:

a utilising funding with deposit-like characteristics;
b performing maturity or liquidity transformation, or both;
c undergoing credit risk transfer; and
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 ETFs, 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 reforming the securities law;

164 Directive 2007/44/EC.
165 Available at ec.europa.eu/finance/general-policy/shadow-banking/index_en.htm.
166 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.
167 Available at www.financialstabilityboard.org.

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c increasing the transparency of the shadow banking sector (e.g., through the collection and storing of trade data);
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 OJ on 30 June 2017 and has generally applied from 21 July 2018. It defines MMFs as CIUs that require authorisation as UCITS or are authorised as UCITS under UCITS IV, or are an AIF under the AIFMD; invest in short-term assets; and have distinct or cumulative objectives offering returns in line with money market rates or preserving the value of the investment.[168]

The MMF Regulation also categorises MMFs, and includes provisions on, among other things, eligibility criteria for assets in which MMFs can invest and diversification requirements.

In November 2017, ESMA published its a final report on certain Level 2 and Level 3 measures under the MMF Regulation.[169] In March 2018, ESMA published guidelines on the scenarios that the Regulation requires MMFs to factor into their stress-testing processes.[170] In accordance with the MMF Regulation, ESMA must update its guidelines at least annually, taking into account the latest market developments. Accordingly, in September 2018, ESMA published a consultation paper setting out draft 2019 guidelines on stress test scenarios under the MMF Regulation.[171]

XI PACKAGED RETAIL AND INSURANCE-BASED INVESTMENT PRODUCTS REGULATION

In November 2010, the Commission identified concerns in the EU retail investment market and launched a consultation on packaged retail and insurance-based investment products (PRIIPs). It considered, among other things, that information about investments was weak and difficult to comprehend and use by consumers; there were many conflicts of interest present in the distribution of investment products; and the regulation of the market was fragmentary and inconsistent. The Commission noted that these issues created risks for consumers.[172]

168 Article 1(1) MMF Regulation.
169 Available at https://www.esma.europa.eu/sites/default/files/library/esma34-49-103_final_report_on_mmf_cp.pdf.
170 Guidelines: Guidelines on stress tests scenarios under Article 28 of the MMF Regulation (ESMA34-49-115); available at https://www.esma.europa.eu/sites/default/files/library/esma34-49-115_mmf_guidelines_on_stress_tests.pdf.
171 Consultation Paper: Draft guidelines on stress test scenarios under the MMF Regulation (ESMA34-49-131); available at https://www.esma.europa.eu/sites/default/files/library/esma-34-49-131_cp_on_mmf_stress_test.pdf.
172 European Commission, Working Document of the Commission Services (DG Internal market) – Consultation by Commission Services on legislative steps for the Packaged Retail Investment Products Initiative.

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Further, PRIIPs do not tend to be harmonised products at the European level and can span a range of different investment products, although their unifying feature is that they are marketed to retail customers. PRIIPS can include investment funds, insurance-based investment products, retail structured securities and structured term deposits. To address some of the concerns raised in its consultation, the Commission decided to introduce a new, pre-contractual disclosure document (a key information document, or KID) for retail consumers. The rationale was that consumers would be able to refer to the KID when considering buying a PRIIP. The Commission also decided to address this issue through cross-sectoral legislation, which would apply across various existing regulations.[173] The Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation entered into force on 29 December 2014, and it became applicable on 1 January 2018.[174] The Commission also developed regulatory technical standards on KIDs in the delegated regulation relating to the PRIIPS Regulation, which also became applicable on 1 January 2018.[175]

The PRIIPs Regulation and related delegated regulation specify the form and content of the KID, favouring a simple, clear and easy to understand format. The PRIIPs Regulation also lays down rules on how to provide the KID to retail investors. It applies to PRIIP manufactures who are responsible for drawing up KIDs.[176] PRIIP manufacturers are defined as an entity that manufactures PRIIPs or makes changes to an existing PRIIP, for example by altering its risk and reward profile. Therefore, this would capture fund managers, insurance companies, investment firms and banks. The PRIIPS Regulation also applies to persons advising on or selling PRIIPs, who must provide the KID to retail investors.[177]

Articles 15 to 18 of the PRIIPs Regulation also provide national competent authorities and EOPIA with the power to monitor financial products under their supervision and prohibit or restrict the sale of certain products in the case of, for example, investor protection concerns or a threat to the orderly functioning and integrity of financial markets. Among other initiatives, the ESAs published technical advice on the inclusion of environmental or social objectives targeted by a PRIIP in a KID (pursuant to Article 8(4) of the PRIIPs Regulation).[178]

XII SECURITIES FINANCING TRANSACTIONS REGULATION

As part of its work on reforming the shadow banking sector, in January 2014, the Commission published a legislative proposal for a Regulation on reporting and transparency of financing transactions (the Securities Financing Transactions Regulation, or, SFTR). One of the central aims of the proposed SFTR was to enhance transparency and data availability in respect of transactions frequently undertaken in the shadow banking sector such as repurchase agreements and securities lending, commonly known as securities financing transactions

173 European Commission, Proposal for a regulation of the European Parliament and of the Council on key information documents for investment products, 3 July 2012.

174 Regulation 1286/2014.

175 Delegation Regulation (EU) 2017/653.

176 Articles 4(4)(a) and 5, PRIIPs Regulation.

177 Articles 4(4)(b), 13 and 14, PRIIPs Regulation.

178 European Supervisory Authorities, Joint Technical Advice on the procedures used to establish whether a PRIIP targets specific environmental or social objectives pursuant to Article 8(4) of Regulation (EU) No. 1286/2014 on key information documents (KID) for packaged retail and insurance-based investment products (PRIIPs), 28 July 2017.

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(SFTs). The proposal sought to improve transparency in three main areas: '(1) the monitoring of the build-up of systemic risks related to SFT transactions in the financial system; (2) the disclosure of the information on such transactions to the investors whose assets are employed in these or equivalent transactions; and (3) the contractual transparency of rehypothecation activities.'[179] To that end, the SFTR requires counterparties to SFTs to report details of those transactions to trade repositories. UCITS management companies and AIFMs must make certain disclosures relating to SFTs to investors in their funds, including identifying the SFTs and total return swaps that the funds in question are authorised to use. Certain information relating to SFTs must also be disclosed in UCITS' semi-annual and AIFs' annual reports to investors. The SFTR also imposes conditions on the reuse of collateral received by counterparties to SFTs, including the provision of pre-contractual information on the risks of reuse and a requirement to obtain prior express consent thereto.

On 12 January 2016, the Securities Financing Transactions Regulation[180] came into force. It has applied, for the most part, since that date. Regulatory Technical Standards and Implementing Technical Standards supplementing the SFTR came into force on 11 April 2019.

XIII ELTIFS, EUVECAS AND EUSEFS

In recent years, a number of new types of investment fund have been introduced following legislative initiatives by the Commission, each, in turn, an elaboration of the AIF concept. One of those initiatives was the European Venture Capital Funds Regulation (EuVECA) Regulation,[181] which aims to strengthen the ability of venture capital funds to raise money across the EU by creating a new brand of investment fund targeted at investors who wish to gain exposure to venture capital investments. To be an EuVECA, a fund must meet certain eligibility criteria including that it is an EU AIF that invests at least 70 per cent of its aggregate capital contributions to qualifying investments (i.e., venture capital investments).

The European Social Entrepreneurship Funds Regulation (the EuSEF) Regulation[182] also created a new brand of EU AIF that, in summary, intends to invest at least 70 per cent of its aggregate capital contributions in investments that primarily aim to achieve positive social impacts. Most provisions in the EuVECA Regulation and the EuSEF Regulation have applied since 22 July 2013, the date on which Member States were required to implement the AIFMD.

The aim of the ELTIF Regulation is to create a new type of investment fund designed for investors who were prepared to make long-term investments in companies and projects in return for a steady income. To qualify as a European Long Term Investment Fund, a fund must be an EU AIF, be authorised by the competent authority in its home Member

179 Commission proposal for a Securities Financing Transactions Regulation, page 3.

180 Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No. 648/2012.

181 Regulation (EU) No. 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds.

182 Regulation (EU) No. 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

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State, and comply with the rules in the ELTIF Regulation, including rules on investment policies, redemption, marketing and transparency. The ELTIF Regulation came into force on 8 June 2015, and has applied since 9 December 2015.

XIV TAX LAW

Taxation remains largely a matter for the Member States. With the exception of value added tax (VAT), there is currently no centralised tax affecting asset management. Nevertheless, EU law materially impacts Member States' tax laws and, therefore, the tax treatment of asset management within the EU.

i Withholding taxes

Historically, fund structures may have been set up to take advantage of the Parent Subsidiary Directive (PSD)[183] or the Interest and Royalties Directive (IRD),[184] or both. Broadly, the PSD and the IRD provide for an exemption from withholding tax on, respectively, payments of dividends to qualifying corporate shareholders holding at least holding 10 per cent of the payor's share capital and payments of interest and royalties between associated companies.

The Danish conduit cases[185] have cast doubt on the circumstances in which taxpayers may rely on the PSD and the IRD. In each case, structures had been set up to take advantage of the PSD or the IRD and the Danish tax authorities denied the exemption on the basis that the recipient was merely a conduit and the actual beneficial owners of the payments were non-EU entities. The Court of Justice of the European Union (CJEU) held that the benefit of the IRD and the PSD must be denied in the case of an abuse of rights – for instance, where a structure is set up with the intention of claiming the exemption by artificially creating the preconditions for it, such that the formal conditions of the IRD or the PSD are met, but not their purpose. The CJEU indicated that the following factors would be taken into account in determining whether there is an abuse of rights: the circumstances around the set-up of the structure; a quick on-payment of payments received; the recipient's ability to economically benefit from, and determine how to use, the payments received; and the recipient's other activities (if any).

Given that the PSD and IRD apply only in respect of intra-EU payments, payments to and from UK companies will no longer be covered after 2020 (unless a contrary agreement is reached between the UK and the EU), meaning that the relevant provisions of applicable double tax treaties would instead have to be relied on, and those provisions may not provide for a full exemption from withholding tax. Problems may, therefore, arise in respect of payments to the UK and UK source interest payments. As the UK does not generally impose a dividend withholding tax, issues in respect of payments of dividends by UK companies are unlikely to arise.

183 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

184 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

185 Joined cases *N Luxembourg 1* (Case C-115/16), *X Denmark* (Case C-118/16), *Danmark I* (Case C-119/16) and *Z Denmark* (Case C-299/16) *v. Skatteministeriet*; and joined cases *T Danmark* and *Y Denmark Aps* (C-116/16 and C-117/16).

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ii Fundamental freedoms under the TFEU

Each of the four fundamental freedoms enshrined in the Treaty on the Functioning of the European Union (TFEU) has direct effect, meaning that each of them applies without the need for national implementing legislation and can directly affect national tax rules. Of the four fundamental freedoms, the most relevant in the asset management context are the freedom of establishment under Article 49 TFEU and the free movement of capital under Article 63 TFEU (for these purposes, 'capital' includes units of CIUs).[186] In most cases, the same result would be reached irrespective of the applicable freedom. Given, however, that the application of these two freedoms is mutually exclusive, it is important to take note of their key differences. While both freedoms are subject to certain restrictions, the restrictions that may be imposed on the free movement of capital are more extensive. In particular, Member States may restrict the free movement of capital (but not the freedom of establishment) to apply provisions of their tax law that 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[187] and to take all requisite measures needed to prevent infringements of their laws and regulations.[188] Another key difference between these two fundamental freedoms is that only nationals of, and companies formed in, Member States may rely on Article 49 TFEU, whereas Article 63 TFEU applies to movements of capital between Member States as well as between Member States and third countries. After 2020, the UK would be a third country for these purposes.

In the asset management context, the impact of the two freedoms on the taxation of dividend flows is particularly important in situations where the recipient cannot rely on the PSD. In the 2009 case *Aberdeen Property Fininvest Alpha Oy*,[189] it was held that, under Article 49 TFEU, it is not permissible for a Member State to impose a withholding tax on dividends distributed to a parent company in form of an open-ended investment company resident in a another Member State when similar dividends paid to comparable domestic parent companies are not subject to such withholding tax. In other cases, it was held that Article 63 TFEU precludes the imposition of withholding tax on dividends distributed to a foreign company, UCITS or pension fund established in a different Member State if dividends distributed to a domestic company, UCITS or pension fund were not also subject to such withholding tax or, if in principle also subject to such withholding tax, were effectively exempt from it.[190] In *Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy*, it was decided that Article 63 TFEU prevents a Member State from withholding tax from dividends distributed to an investment fund established in a third country if a similar withholding tax is not imposed on dividends distributed to investment funds established in

186 See Category IV of the list of capital movements in the Nomenclature in Annex I to the Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

187 Article 65(1)(a) TFEU.

188 Article 65(1)(b) TFEU.

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

190 *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam* (Case C-379/05); *Santander Asset Management SGIIC SA v. Directeur des résidents à l'étranger et des services généraux* (C-338/11); and *European Commission v. Finland* (Case C342/10).

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that Member State and there is a mutual administrative assistance obligation between that Member State and that third country which enables the tax authorities in that Member State to verify information provided by the investment fund.[191]

iii State aid

Article 107 of the TFEU prohibits 'state aid', meaning measures taken by a Member State to favour certain undertakings, industries or goods in a way that could distort competition and affect trade between Member States. Such measures may take the form of selective benefits, such as subsidies, or 'interventions which, in various forms, mitigate the charges that are normally included in the budget of an undertaking'.[192]

The state aid regime can apply to the tax rules of a Member State if they are, or are applied in a manner that is, 'selective' in favour of a particular undertaking, category of undertakings or category of goods. The Commission has, in particular, challenged a number of tax rulings on state aid grounds. Whilst the General Court has recently ruled against the Commission on some of these challenges,[193] it is still advisable to consider the risk of potential state aid challenges, in particular where structures rely on tax rulings (or otherwise on favourable regimes).

iv Exchange of information

Under the Directive on Administrative Cooperation (DAC)[194] and various amendments thereto, Member States are obliged to implement procedures for the collection and sharing of certain information in relation to tax matters. Of particular note are:

a DAC3,[195] which provides for the automatic exchange between tax authorities of cross-border tax rulings and advance pricing agreements. Clearly, this adds a potential further layer of scrutiny of such rulings and agreements where authorities may already be daunted by the spectre of potential state aid challenges from the Commission; and

b DAC6,[196] which introduces mandatory disclosure rules for intermediaries such as lawyers, accountants and tax advisers in respect of 'reportable cross-border arrangements', a term that is broadly defined and may catch fund or acquisition structures. Originally, the first disclosures were required to be made by the end of July

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

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

193 See joined cases *Netherlands v. Commission* (T-760/15) and *Starbucks and Starbucks Manufacturing Emea v. Commission* (T-636/16), and joined cases *Ireland v. Commission* (T-778/16) and *Apple Sales International and Apple Operations Europe v. Commission* (T-892/16). The Commission's decision that a ruling given by Luxembourg to Fiat constituted unlawful state aid was, however, upheld by the General Court (joined cases *Luxembourg v. Commission* (T-755/15) and *Fiat Chrysler Finance Europe .v Commission* (T-759/15)).

194 Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC.

195 Council Directive (EU) 2015/2376 of 8 December 2015 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation.

196 Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements.

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2020, but most Member States have made use of the option to defer the first reporting deadlines by six months. This option was introduced in June 2020 in light of the continuing covid-19 pandemic.[197]

v VAT

Under Directive 2006/112/EC, the Principal VAT Directive (PVD),[198] a common system of VAT has been established in the EU under which VAT may be chargeable in respect of goods and services supplied in the course of carrying on a business. Asset management services provided to a fund by an asset manager would normally be a service supplied in the course of carrying on a business for these purposes.

Broadly speaking, unless an exemption applies, VAT is chargeable on the consideration paid for such services at a rate set by the relevant Member State. Normally, unless the supply of services is cross-border, the supplier (i.e., the asset manager) would have to account to the relevant tax authorities for the applicable VAT and would pass the cost on to the recipient of the supply (i.e., the fund). This is likely to be a real cost for the fund (and, ultimately, the investors) because amounts paid to suppliers in respect of VAT can only be recovered from the relevant tax authorities if the fund also makes supplies subject to VAT – which is unlikely. Therefore, from the investors' perspective, it would likely be advantageous if the asset management services fell within an exemption from VAT. (From the asset manager's perspective, that would be disadvantageous because it would mean that the asset manager makes supplies which are not subject to VAT and, therefore, the asset manager's ability to recover from the relevant tax authorities amounts that it has paid to its own suppliers in respect of VAT is limited, thereby reducing its own profit margin.)

Generally, asset management is a service subject to VAT, but there is an exemption for 'the management of special investment funds as defined by Member States'.[199] Within the confines of the objective of the VAT Directive and the principle of fiscal neutrality, each Member State has discretion to define the scope of the 'special investment fund' (SIF) exemption and, over the years, a number of cases have been brought in the European Courts in respect of it. It has been held that the term SIF is specific to the business of undertakings in collective investments,[200] but that it cannot be defined to refer to portfolio management in general;[201] nor can it be defined in a way that distinguishes between open and closed-ended funds.[202] It has also been held that the term does not extend to defined benefit pension schemes or common investment funds pooling the assets of such schemes,[203] but that it may

197 Council Directive (EU) 2020/876 of 24 June 2020 amending Directive 2011/16/EU to address the urgent need to defer certain time limits for the filing and exchange of information in the field of taxation because of the covid-19 pandemic.

198 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

199 Article 135(1)(g) of the PVD.

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

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

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

203 *Wheels Common Investment Fund Trustees and Others v. Commissioners for Her Majesty's Revenue and Customs* (C-424/11). The claimant in the UK High Court case *United Biscuits (Pension Trustees) Ltd and another v. HMRC* [2017] EWHC 2895 sought to challenge this position, arguing that similar fund management services are exempt under Article 135(1)(a) of the PVD (exemption from VAT for 'insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents').

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extend to certain defined contribution pension schemes where the scheme members bear the investment risk.[204] The exemption may also 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), but only to the extent that fund-specific functions, such as investment recommendations and portfolio management, are concerned; the exemption does not apply to the actual management of the immovable property of the fund.[205] Most recently, the CJEU indicated that the services provided through Blackrock's Aladdin platform do not fall within the SIF exemption.[206]

The amount of case law demonstrates a degree of uncertainty around the scope of the SIF exemption, which is unfortunate and undesirable. If asset management services have been priced on the assumption that the SIF exemption does not apply, the pricing may have to be revisited if this assumption is proven incorrect following a later court decision. In the meantime, the asset manager may have recovered amounts from the tax authorities that it was not entitled to recover and accounted to the tax authorities for VAT that was not due, and this situations would, somehow, have to be unwound. To the extent that VAT costs have been borne by the fund, investors would want to ensure that the asset manager reclaims from the tax authorities any amount of VAT for which it erroneously accounted and passes any refund on to the fund.

vi Financial transaction tax

On 28 September 2011, the Commission presented a formal proposal for a financial transaction tax (FTT) to be levied at a rate of 0.1 per cent on transactions in shares and bonds, and at a rate of 0.01 per cent on derivative contracts. It appears that 10 Member States continue to work towards the introduction of an FTT through the enhanced cooperation procedure,[207] but significant further work is required, and it is not clear when (or, indeed, if) agreement on the FTT can be reached.

vii Commission's tax action plan

On 15 July 2020, the Commission published its 'Action Plan for fair and simple taxation supporting the recovery strategy'[208] which envisages that, amongst others, tax competition will be more tightly controlled and the VAT rules on financial services modernised. Alongside

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The UK High Court considered that the provision of pension fund management services did not comprise 'insurance' for the purposes of Article 135(1)(a) of the PVD, with the result that the VAT exemption did not apply to the provision of such services (whether by insurers or non-insurers). The claimant appealed to the UK Court of Appeal which referred the question to the CJEU whether the services in question constituted 'insurance transactions' within the meaning of the PVD (see *United Biscuits (Pensions Trustees) and United Biscuits Pension Investments* (C-235/19)). Advocate General Pikamäe opined that they did not, but it remains to be seen whether the CJEU agrees.

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

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

206 *Blackrock Investment Management (UK) Limited v. Commissioners for Her Majesty's Revenue and Customs* (C-231/19).

207 Council, Note, ECOFIN Report to the European Council on tax issues published on 9 December 2019 and available under the following link: https://data.consilium.europa.eu/doc/document/ST-14863-2019-INIT/en/pdf.

208 https://ec.europa.eu/taxation_customs/sites/taxation/files/2020_tax_package_tax_action_plan_en.pdf.

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the Action Plan, the Commission published the proposed text for DAC7, a directive to amend the DAC to extend existing provisions on the exchange of information on request and provide for the automatic exchange of information reported by digital platform providers.[209]

XV SUSTAINABLE FINANCE

The past couple of years have seen institutional investors play a more active role in holding companies to account and engaging in environmental, social and governance issues (ESG). In a similar vein, asset managers are increasingly expected by their clients to consider ESG in their investment decisions. Despite this, in a 2016 consultation, the Commission found that although ESG factors are perceived as important among investors and asset managers, most investment decisions were made on a short-term basis.[210]

In light of this, the Commission established a high-level expert group (HLEG) on sustainable finance in 2016 to prepare a blueprint for reforms to the financial sector, focusing on mobilising private capital towards sustainable investments. The Commission considered that the financial sector has a role to play in helping Member States achieve their ESG goals encapsulated in, among other initiatives, the Paris Agreement (signed on 12 December 2015) and the Sustainable Development Goals (adopted on 25 September 2015). On 31 January 2018, the HLEG published a final report with recommendations ranging from establishing a common sustainability taxonomy for financial products to clarifying investor duties for ESG and upgrading disclosure rules to make sustainability risks more transparent.[211]

The Commission published its action plan on 8 March 2018, which built on the HLEG's recommendations and set out a timetable for the implementation of its proposals.[212] On 24 May 2018, the Commission presented a package of measures that includes its main three proposals:

a the development of an EU taxonomy for climate change and environmentally and socially sustainable activities to be able to accurately assess financial products (the Taxonomy Regulation);

b creation of a new category of benchmarks to help investors compare the carbon footprint of their investments (the Low Carbon Benchmark Regulation); and

c disclosure requirements and integration of ESG in investment decisions (the Disclosure Regulation).

The Low Carbon Benchmarks Regulation and the Disclosure Regulation were published in the OJ on 9 December 2019.[213] The Low Carbon Benchmark Regulation entered into force on 10 December 2019. The Disclosure Regulation entered into force on 29 December 2019, with a minority of its provisions applying from that date and 1 January 2022, and the

209 COM(2020) 314 final published on 15 July 2020 and available under the following link: https://ec.europa.eu/taxation_customs/sites/taxation/files/2020_tax_package_dac7_en.pdf.

210 European Commission, Summary of the responses to the public consultation on long-term and sustainable finance, October 2016.

211 EU High-Level Expert Group on sustainable finance, Financing a sustainable European economy – Final Report 2018, 31 January 2018.

212 European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions – Action Plan: Financing Sustainable Growth, 8 March 2018.

213 Regulation (EU) 2019/2089.

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majority applying from 10 March 2021. The Framework Regulation was published in the OJ on 22 June 2020, entered into force on 20 July 2020 and will apply in stages from 1 January 2022 and 1 January 2023.

The Commission has also published for consultation draft amendments to delegated acts of MiFID II and the Insurance Distribution Directive[214] to enhance sustainability in suitability assessments.[215]

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Appendix 1

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