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Evolving Investment Management Regulation

Succeeding in an uncertain landscape

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Chapter **5**

Cross-border business meets major crossroads

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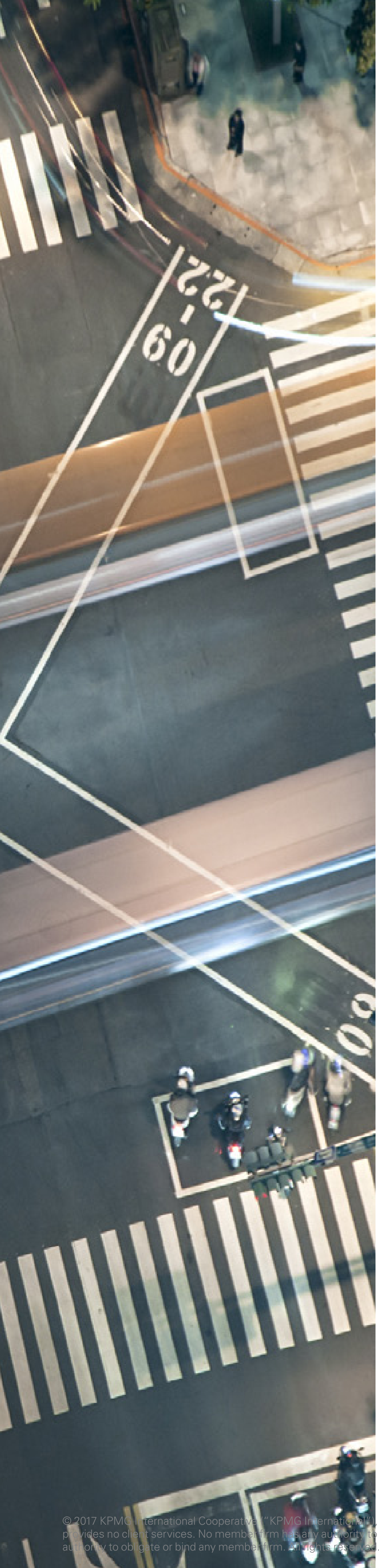
The impacts of regulation on the cross-border distribution of funds or investment management services – whether enabling or restricting – have been carefully watched by the industry for many years.

The cross-border fund passport, which was kicked off in **Europe** by UCITS nearly 30 years ago, has spread to other funds and other parts of the globe. The passporting trend has seemingly been unstoppable — a natural adjunct to the increasing globalization of financial services. However, obstacles to this trend have appeared, within both **Asia** and Europe.

And a much more significant obstacle looms on the close horizon, for both funds and investment management — "Brexit". The **UK**'s decision to leave the EU is a national decision, but Brexit will be an international event with significant regulatory ramifications, around Europe and globally.

Meanwhile, some regulators remain intent on opening up their capital markets, which should be good news for investment managers.



Asia: Are bilateral agreements more promising than regional passports?

In EIMR 2016, we commented extensively on the three **Asian** passports under development. The three – the China Mainland-Hong Kong Mutual Recognition of Funds (MRF), the Asian Region Funds Passport (ARFP) and the Association of South-East Asian Nations Collective Investment Scheme Framework (ASEAN) – have had varying fortunes.

We noted that under the MRF there had been more "southbound" activity than "northbound". This reflected restrictions on the size of northbound flows to prevent **Hong Kong** investment firms setting up funds purely to be distributed in **China** to take advantage of the huge untapped market. Chinese funds, which tend to be larger, were seeing fewer opportunities to distribute into the Hong Kong market.

Little has changed since then and activity, if anything, has slowed down. Only a handful of Hong Kong funds have been approved for distribution in mainland China and there have been no new approvals for months.

Progress on the agreement to formalize the ARFP, which combines the initial signatories **Australia, New Zealand, Singapore** and **South Korea,** with the **Philippines** and **Thailand**, has also been slow. While a Statement of Understanding was signed in September 2015, negotiations have been bogged down since. Singapore left the group, saying it would consider returning only when a number of tax considerations are clarified.

Some progress was finally achieved in April 2016, when representatives from **Australia, Japan, New Zealand** and **South Korea** signed the ARFP Memorandum of Cooperation (MoC). **Thailand** was a subsequent signatory.

The MoC came into effect on 30 June 2016, with participating jurisdictions having 18 months to implement domestic arrangements to comply with the ARFP regime.

Regarding ASEAN, there has been little or no new activity since last year, but Singapore continues to be a strong supporter of this passport initiative.

Despite the somewhat disappointing take-up of the regional passporting schemes, there has been progress in bilateral agreements. In December 2016, for instance, the People's Bank of **China** granted **Ireland** a RMB50 billion quota under the RQFII Scheme[44], which will allow Irish-domiciled funds to purchase securities in local Chinese Markets. Further enhancing Irish funds' ability to access Chinese mainland markets, the Chinese Central Bank also said it would begin accepting applications for investment through Shenzhen Connect, to which Irish funds were granted access in 2015.

Similarly, under a memorandum of understanding between **Hong Kong**'s SFC and the **Swiss** Financial Market Supervisory Authority, eligible Swiss funds can now be sold in Hong Kong, and eligible Hong Kong funds will enjoy the same treatment in Switzerland.

Non-European alternative funds still await the passport

The AIFMD provides that, three months after receiving a positive opinion from ESMA, the Commission may introduce a third-country passport that allows AIFs in non-EU countries to be sold cross-border to EU professional investors and non-EU managers to manage EU AIFs. However, the Commission has still not granted the passport to any non-EU countries, despite ESMA's advice in July 2016 that the passport should be given to 12 non-EU countries.

[44] Renminbi Qualified Foreign Institutional Investor

AIFMD non-EU passports – ESMA's advice of July 2016

- No significant obstacles impeding the application of the AIFMD passport to **Canada, Guernsey, Japan, Jersey** and **Switzerland**.
- No significant obstacles for **Hong Kong** and **Singapore**. However, both jurisdictions operate regimes that facilitate the access of UCITS from certain EU Member States only.
- No significant obstacles for **Australia**, provided the Australian Securities and Investments Commission (ASIC) extends to all EU Member States "class order relief".
- No significant obstacles for the **US**. However, for funds marketed by managers to professional investors that do involve a public offering, a potential extension of the AIFMD passport to the US risks an uneven playing field between EU and non-EU AIFMs. The conditions that would apply to these US funds would potentially be less onerous. ESMA recommends that the EU institutions consider options to mitigate this risk.
- For **Bermuda** and the **Cayman Islands**, ESMA could not give definitive advice. Both countries are in the process of implementing new regulatory regimes.
- For the **Isle of Man**, ESMA finds that the absence of an AIFMD-like regime makes it difficult to assess investor protection.

The Commission has indicated that there are a number of issues to resolve, including taxation and anti-money laundering (AML). It now seems likely that third countries might have to wait until deep into 2018 for progress. A European Council group is preparing a consolidated list of "non-co-operative" jurisdictions from a tax perspective. Countries are being assessed on their approach to issues such as their commitment to tax transparency, "fair" taxation, and implementation of anti-tax avoidance measures under the OECD's Base Erosion and Profit Shifting program.

The Commission may decide to delay extending the AIFMD non-EU passport until this work is nearer completion. Industry commentators have questioned whether the delay is also partly due to Brexit, given the large number of **UK** AIFs and UK AIFMs that currently operate under the AIFMD's EU passport.

Some jurisdictions are not overly concerned by the lack of introduction of the non-EU passport. The **Isle of Man**, for example, has decided not to aim for AIFMD equivalence. Also, for some asset classes, the national private placement regimes continue to be workable for the time being.

Brexit – UK decision, global issue

The industry now faces potentially the single biggest impact on cross-border financial services in a generation – Brexit. Considered an unlikely event in early 2016, here we are in 2017 with Article 50 triggered and a 2-year timetable in place for the **UK**'s exit from the EU.

Brexit is not just about the future of London as a financial center or of the UK-based investment and fund management industry. Firms within other EU Member States ("EU27") and elsewhere will be impacted.

Much business takes place from and to the UK via EU regulatory passports. For funds and management companies (ManCos) the key passports are in the UCITS Directive and the AIFMD. For the provision of investment management services, the MiFID II passport is king. The passports work differently in all three directives and their loss would have different impacts in the retail and professional marketplaces.

Equivalence – a poor substitute

There is a diversity of "third-country" provisions under different pieces of EU legislation and some have no formal "equivalence" regime. The provisions in MiFID II, AIFMD and the UCITS Directive are all quite different, for example.

Equivalence regimes cover only a subset of the activities that currently benefit from passports for EU firms. Therefore, unless the final trade agreement between the EU and the UK includes arrangements for UK firms to continue to benefit from all EU passports (which, politically, seems unlikely), Brexit will result in EU27-UK cross-border business being prohibited or restricted.

Moreover, gaining equivalence status is neither a singular nor a one-off process for a third country – it requires a different judgment for each piece of legislation and those judgments are subject to review at any time.

ESMA has said that the EU framework for third countries is not fit for purpose and requires overhaul. In fact, there is no generic framework, with different arrangements in different pieces of legislation – which are a mixture of equivalence, endorsement, recognition or passporting – or no arrangement at all. Also, it is time- and resource-intensive, requiring detailed assessments of third countries' regimes and lengthy negotiations if a country is not initially judged equivalent.

Implications of the loss of the three key EU passports

UCITS

UCITS are, by definition, EU-domiciled funds with EU-domiciled ManCos. Therefore, absent a specially negotiated deal and changes to UCITS legislation, UK UCITS will no longer be UCITS and UK ManCos will no longer be able to be ManCos for EU27 UCITS.

EU27 UCITS invested in UK UCITS may have to divest, unless UK UCITS are accepted as "equivalent".

There is no obvious regulatory reason why EU27 UCITS should be prevented from marketing to UK retail investors. However, if UK UCITS can no longer be sold into the EU, there is a political risk that EU27 UCITS will no longer be able to access UK retail investors.

AIFs

Unlike the UCITS Directive, both AIFs and AIFMs may be EU or non-EU. Therefore, in theory, there is nothing at EU level to prevent EU27 AIFs continuing to be sold into the UK (and vice versa), or for EU27 AIFMs to manage UK AIFs (and vice versa).

However, the AIFMD non-EU passports have not been introduced and a number of the EU27 do not have, or have very restrictive, private placement regimes. If UK AIFs cannot be sold into these countries, there is a political risk that AIFs domiciled in those countries will not be able to be marketed into the UK.

Some Member States allow UK authorized retail AIFs to be sold to retail investors in their country, and vice versa. Again, there is a political risk of these arrangements being disrupted.

Investment management of funds

Both the UCITS Directive and AIFMD allow the investment management function to be delegated, provided there is still "substance" in the home Member State.

ESMA is promoting a common understanding of the substance requirements for UCITS ManCos and AIFMs. It has also called for the disparate third-country regimes in EU legislation to move to a common approach. Brexit adds political momentum to both these debates.

Investment management of separately managed accounts

Under MiFID II, UK firms should be able to continue to provide investment management services to EU professional clients. However, the client may itself be subject to national rules that restrict its choice of investment manager (e.g. some pension funds). This is mainly an issue for UK-based investment managers, but, again, there is a political risk of similar issues for EU27 firms that provide investment management services to UK professional clients.

In the wealth management arena, EU27 firms may not be able to market their services to UK clients, and vice versa.

Mr. Maijoor cited the equivalence system under EMIR: "The EU is an island of third-country reliance in a world that has mostly opted for individual registration of CCPs that want to do cross-border business." ESMA has limited opportunities to see the specific risks that third-country CCPs might be creating in the EU as it has limited powers regarding information collection and risk assessment, and no regular supervision and enforcement tools.

It remains to be seen how quickly and in what ways the co-legislators will respond to this call for an overhaul of the system. Certainly, it would be a major drafting and practical task to bring about greater consistency of approach. Political pressures, in Europe and beyond, may provide momentum behind the task. In the meantime, firms and market entities will wish to factor into their business planning that the third-country provisions of today may look rather different in a few years.

UK trade agreements with non-EEA countries

The day of Brexit will not be the end of the story. The UK will need to negotiate new trade agreements with non-EEA countries where it currently benefits from EU agreements. The time gap in securing these agreements will impact firms in the UK, across Europe and more widely.

For example, business is currently done between the UK and **Switzerland** under Switzerland's trade agreement with the EU. Post-Brexit, this business will be uncertain until the UK agrees a new trade deal with Switzerland. Not only will UK and Swiss firms be affected: other firms (within the EEA or elsewhere) with operations in both the UK and Switzerland, and which depend on that border remaining open, will be impacted too.

Many other Brexit issues to navigate

In addition to the three main regulatory passports, EU investment and fund managers benefit from a number of other passports, protections and activities that will be impacted by Brexit. Here are just a few:

Post-Brexit, UK financial instruments and UK regulated markets will no longer

> "... the UK's decision to leave the EU results in increased risks to consistent supervision."

be EU/EEA instruments and markets. A number of professional clients are required to be predominantly invested in EU/EEA financial instruments or to trade via EU/EEA regulated markets. Investment managers will have to adjust these clients' portfolios.

As the investment banks adjust their operations, so the capital markets, market liquidity and trading venues will change and evolve. The front offices of investment managers will have to adapt to these changes and they may have to change their internal dealing support systems.

Even if firms do not relocate any of their operations (from or to the UK), they will have to navigate contract law, employment law and tax law issues: for example, what will happen to VAT arrangements for EU27 members with operations in the UK? What impact might there be on the process for tax treaty claims?

Some EU27 members route data via the UK and then on to other destinations (e.g. the US). How will this work post-Brexit under the new EU General Data Protection Regulation (GDPR), which includes specific extra-territoriality provisions?

EU Member States vie for UK firms and talent

Since the Brexit vote, there has been no shortage of pronouncements from EU Member States hoping to increase their share of investment management and fund activities, including **France, Germany, Ireland, Italy** and **Malta**. And other countries' regulators are positioned to deal with more applicants.

In October 2016, **France**'s AMF unveiled a new program designed to help foreign investment managers and other financial firms navigate the authorization process. Existing documents already approved by the UK regulator are sufficient – French-specific documents need not be drawn up – and an English-speaking contact point will be in place to assist applicant firms. The "one-stop shop offer" provides a pre-authorization procedure, allowing firms to begin opening offices in France in just 2 weeks.

Also, in March 2017, the AMF announced, that under the "FROG" initiative, it is reviewing its approach in a number of areas, including allowing French fund managers to delegate to appropriately authorized investment managers and not only to other fund managers.

Germany is considering changing its labor laws to make Frankfurt a more attractive hub for investment managers and other financial services firms looking to move staff out of London. One German website, which went live immediately after the UK vote, reads "Welcome to FrankfurtRheinMain" and offers a 24-hour UK-based hotline for companies thinking of opening an office in the area.

Ireland's central bank has seen a "material increase" in the number of authorization queries from UK firms looking to establish a presence in Dublin following the Brexit vote. The regulator has stated its commitment to transparency, consistency and predictability in its approach to authorizations, and has made public considerable information on Brexit-related authorizations.

The **Luxembourg** regulator has confirmed being faced with an increased demand from UK-based investment and fund managers, and that it will only authorize new firms in line with existing EU requirements, notably regarding substance.

In December 2016, **Spain** launched a campaign designed to attract UK-based investment managers and other financial services firms. The CNMV created a "dedicated welcome program" designed to "contribute to making Spain the most appealing option for investment firms considering a move from the UK to another EU country". It plans to create a single contact point for applicants, provide and accept documentation in English, and establish a two-month fast-track authorization process for UK firms following a two-week pre-authorization period.

Increased competition to London may also lie outside the EU. The government of **Switzerland** said in a federal council report, "Financial Market Policy for a Competitive Swiss Financial Centre", that Switzerland's investment and wealth management industry should be able to capitalize on Brexit. "While asset management and investment banking are well-established strengths of London's financial center and are likely to remain so, Switzerland can build on its strong position in the area of cross-border asset management."

ESMA takes aim at delegation practices

Would-be rivals to London within the EU have been warned that unfair practices to attract business will not be welcomed. ESMA said, in March 2017, that it was investigating risks of "regulatory arbitrage", whereby national regulators try to attract jobs and tax revenue by offering lighter regulatory supervision.

Mr. Maijoor observed that the UK's decision to leave the EU results in increased risks to consistent supervision. He urged national regulators not to compete on regulatory and supervisory treatment, citing the ability for EU firms to delegate or outsource to a UK entity while being registered and supervised by one of the EU27 regulators. In May 2017, ESMA issued nine principles on how to deal with firms that are relocating, with the aim of ensuring a consistent approach to authorisation and supervision, including that the firms must have "substance".

When coupled with the upcoming review of AIFMD and consideration of the future shape of the EU's third-country regimes, fund managers around Europe may have to reconfigure their business models. The common practice of domiciling a fund in one Member State and delegating the investment management function back to the UK is likely to come under increasing scrutiny and regulatory restriction.

EU determined Brexit won't derail CMU

The EU is determined not to let Brexit cause its plans for CMU to meander or fail. A statement by the Commission in September 2016 gave a clear signal that developing stronger capital markets in the EU is still a priority. It called for an acceleration of the reforms, starting with the long overdue securitization package and implementing the Prospectus Regulation.

It unexpectedly launched a Mid-term Review and consultation process on 20 January 2017. The intention was to complete the review in June 2017 with a view to identifying additional measures required to improve the financing of the European economy.

CMU is primarily designed to help channel private savings into the European economy, to the benefit of the economy, capital markets and investors. Its mechanism involves substantial improvements to cross-border distribution, creating large pools of assets from across the Member States.

One of the CMU Action Plan work-streams is to review and address national barriers to the cross-border distribution of investment funds. If funds can do business more easily across borders, they can achieve larger economies of scale and compete to deliver better value and innovation for consumers.

> "... the cross-border fund market is successful but remains geographically limited."

According to Commission statistics, about 80 percent of UCITS and 40 percent of AIFs are marketed across borders, but one-third of these are marketed into only one Member State, usually the state in which the investment manager is domiciled. Another third are marketed into no more than four other Member States.

The Commission's research findings, announced in March 2017, were that the cross-border fund market is successful but remains geographically limited. "The reasons for this may include the concentrated fund distribution channels in individual Member States, cultural preferences and a lack of incentives to compete across borders", the Commission said. Other reasons include the additional national requirements imposed by Member States when transposing AIFMD and the UCITS Directive.

The Commission has identified six categories of national barriers. Their proposed removal will test Member States' commitment to CMU and to the principles of harmonization enshrined in the UCITS Directive and AIFMD.

1. Marketing: Host Member States can set national requirements on financial promotion and consumer protection. This gives rise to initial research costs for firms and to additional ongoing costs.

CMU Mid-Term review: key focus areas

SMEs[45]: Broaden sources of finance, extend geographical reach of financing, and give more access to technology and business know-how. The aim is to enable SMEs to grow faster and, potentially, become European "unicorns".

IPOs[46]: EU public equity and debt markets lag behind other developed economies. To support SME listings, MiFID II will create a new Multilateral Trading Facility category of SME Growth Markets.

Crowdfunding: Divergences in regulation and in interpretation of EU rules may lead to market fragmentation, challenging investor protection.

Venture Capital: Stimulate private funding, and encourage venture debt, private placement and pre-IPO funding.

Corporate bond markets: Review how market liquidity can be improved and the potential impact of regulatory reforms.

Infrastructure: Fund investment shortfalls by mobilizing institutional capital. Regulation may reduce financial institutions' ability to finance long-term investments, in particular infrastructure.

ELTIFs: Facilitate development of the market.

Sustainable investment: Common definitions and standards are lacking.

Fostering retail investment: Consumers lack confidence in capital markets. More transparency around costs and fees is required.

FinTech: Balance between enabling the development of FinTech and ensuring confidence for investors.

Tax: Barriers, notably withholding tax, continue to hinder cross-border investment.

Corporate governance: Divergences in approach may deter investors from investing across borders.

Supervision: Divergences in outcomes lead to cross-border spillovers and unjustified differences in the supervision of the same risk.

[45] small to medium enterprise
[46] initial public offering

> "... retail investors should receive the same level of protection independent of the location of the firm providing the service."

2. Distribution costs and regulatory fees: EU funds can be subject to regulatory fees imposed by home and host Member States that vary significantly in scale and calculation methods.
3. Administration: a number of Member States impose special administrative arrangements to make it easier for investors to subscribe, redeem and receive payments from funds. As part of its background work in producing the final ELTIF RTS, ESMA researched arrangements and found that some Member States force funds to use certain institutions and provide additional information to both the regulator and investors.
4. Distribution networks: despite the increasing use of online platforms to distribute funds nationally, barriers exist across borders.
5. Notification processes: when fund documentation has to be updated, managers are required to give written notice to the host regulator, adding cost and time to the process.
6. Taxation: different tax treatments create barriers to cross-border business. The Commission seeks feedback on how to promote best practice and avoid discriminatory tax treatment.

Meanwhile, ESMA has made it clear that retail investors should receive the same level of protection independent of the location of the firm providing the service. This is seen as important both to the free movement of services within the EU in general and to the success of the CMU initiative in particular.

Other markets opening up

Investors are starting to gain more access to **Indian** markets. The regulator now allows designated foreign portfolio investors to invest in unlisted corporate debt securities and securitized debt instruments in India.

The Dubai Financial Market, one of the **UAE**'s stock exchanges, has launched a platform for transacting in ETFs, which is subject to regulations developed in collaboration with traders. "Dubai Financial Market is committed to its strategy of providing investors with a wide range of innovative products," said Essa Kazim, chairman of the exchange.

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