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THE FUNDS AND INVESTMENT SECTORS

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The current position: UCITS IV

1 The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive provides the main European framework covering collective investment schemes. The regime is now over 30 years old.

2 The original Directive 85/611/EEC was adopted in 1985. It aimed to increase business and investment opportunities for both asset managers and investors by integrating the EU market for investment funds. It set out a harmonised regulatory framework for investment funds which raise capital from the public and invest that capital in certain classes of assets. It sought to provide high levels of investor protection and a basis for the cross-border sale of such funds.

3 UCITS are very popular investments, particularly with small investors seeking diversification. They are widely perceived as being regulated to a certain standard and to have status as a global brand. According to the European Fund and Asset Management Association (EFAMA), the value of the total net assets of UCITS at the end of 2016 was EUR 8,658 billion[1]. The European Commission estimates that UCITS account for around 75% of all collective investments by small investors in Europe. Cross-border marketing plays an increasingly important role in the industry with the UCITS fund passport paving the way for this.

[1] http://www.efama.org/Pages/Net-assets-of-European-investment-funds-rise-to-an-all-time-high-of-EUR-14,142-billion-in-2016.aspx

4 In 2009, the original UCITS Directive was recast. Directive 2009/65/EC (UCITS IV) came into force on 7th December 2009 with its rules applying from 30th June 2011.

5 The introduction of UCITS IV affected UCITS themselves, UCITS managers and UCITS depositaries. Key provisions included:

- the removal of administrative barriers to the cross-border marketing of UCITS;
- the introduction of a provision permitting UCITS managers to passport throughout the EU *via* the provision of services or the establishment of a branch;
- the improvement of co-operation between supervisory authorities and the setting out of information sharing provisions to allow for effective supervision;
- the enhancement of investor disclosure with the replacement of a simplified prospectus by a Key Investor Information (KII) document intended to provide a clearer and more understandable format enabling investors to make informed decisions;
- the introduction of a framework for mergers between UCITS;
- the incorporation of provisions for master-feeder structures.

6 In addition to the Level 1 directive, there are four Level 2 directives or regulations:

- Directive 2010/43/EU (organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company);
- Directive 2010/44/EU (provisions concerning fund mergers, master-feeder structures and notification procedure);
- EU Regulation 583/2010 (key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than by paper or by means of a website);
- EU Regulation 584/2010 (the form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations between competent authorities).

7 There are also Level 3 measures to be observed. These were originally published by the Committee of European Securities Regulators (CESR), this now having been superseded by the European Securities and Markets Authority (ESMA):

- Guidelines on a common definition of European money market funds (ref: CESR/10-049);
- Guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document (ref: CESR/10-673);
- Guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document (ref: CESR/10-674);
- Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (ref: CESR/10-788);
- Selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS (ref: CESR/10-1318);
- Transition from the Simplified Prospectus to the Key Investor Information document (ref: CESR/10-1319);
- Guide to clear language and layout for the Key Investor Information document (ref: CESR/10-1320);
- Template for the Key Investor Information document (ref: CESR/10-1321);
- Guidelines on risk measurement and the calculation of global exposure for certain types of structured UCITS (ESMA/2011/112).

8 UCITS IV was transposed into Gibraltar law by the Financial Services (Collective Investment Schemes) Act 2011 and various domestic regulations:

- Financial Services (Collective Investment Schemes) Regulations 2011
- Financial Services (Collective Investment Schemes) (Corporate Restructuring) Regulations 2011
- Financial Services (Collective Investment Schemes) (Conduct of Business) Regulations 2011
- Financial Services (Collective Investment Schemes) (Key Investor Information) Regulations 2011

- Financial Services (Collective Investment Schemes) (Miscellaneous Provisions) Regulations 2011

The current position: AIFMD

9 UCITS IV is now complemented by the Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD). This came into force on 21st July 2011 with its rules applying from 22nd July 2013. It is supplemented by a Level 2 Commission Delegated Regulation 231/2013.

10 With the implementation of the AIFMD, all EU funds are either UCITS or Alternative Investment Funds (AIFs). The scope of the AIFMD is thus very large and includes Experienced Investor Funds (EIFs), authorised funds, private funds and some recognised funds. Typically, such funds might be private equity funds, hedge funds, property funds or commodity funds. The AIFMD does not directly regulate the operations of AIFs but instead regulates their managers, i.e. Alternative Investment Fund Managers (AIFMs).

11 Small AIFMs (those with assets under management of up to EUR 100 million) do not benefit from any of the rights granted under AIFMD unless they choose to opt in under AIFMD. Where Small AIFMs opt in, AIFMD becomes applicable in its entirety and such AIFMs cease to be Small AIFMs.

12 According to EFAMA, the value of the total net assets of AIFs at the end of 2016 was EUR 5,483 billion[2]. Again, cross-border marketing is significant with the Commission estimating that 57% of UCITS and AIFs are marketed on a cross-border basis.[3]

13 The AIFMD was transposed into Gibraltar law by the Financial Services (Alternative Investment Fund Managers) Regulations 2013.

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[2] http://www.efama.org/Pages/Net-assets-of-European-investment-funds-rise-to-an-all-time-high-of-EUR-14,142-billion-in-2016.aspx

[3] EC Consultation Document, CMU Action on Cross-Border Distribution of Funds (UCITS, AIF, ELTIF, EUVECA and EUSEF) Across the EU (2016): http://ec.europa.eu/finance/consultations/2016/cross-borders-investment-funds/docs/consultation-document_en.pdf

The role of National Private Placement Regimes (NPPRs)

14 A NPPR is a regime agreed between member states which permits the marketing of AIFs which cannot be marketed under the AIFMD passporting regime. NPPRs mainly relate to the marketing of non-EU AIFs and AIFs managed by Small or non-EU AIFMs.

15 The NPPRs impose more onerous burdens in terms of regulatory compliance and coordination than the "one stop shop" passporting regime under AIFMD. Further, the NPPRs in place in certain EU member states (such as France and Italy) are very limited with those jurisdictions being effectively closed to the marketing of AIFs not falling within the passporting regime.

16 So, for example, if a non-EU AIFM wishes to market a Gibraltar AIF within the EU, it will need to do so in accordance with the NPPR in the relevant member state or states.

17 A NPPR is included in the Gibraltar AIFM regime under the Financial Services (Alternative Investment Fund Managers) Regulations 2013. Under this regime:

- to market an EU AIF to experienced and/or professional investors in Gibraltar, it is necessary to complete a NPPR Notification Form;
- to market a non-EU AIF or an EU AIF to retail investors, it is necessary to complete a NPPR Application Form;
- if a non-EU AIFM wishes to market a Gibraltar AIF within the EU, it will need to register in Gibraltar in order to manage the Gibraltar AIF and directly notify each member state into which it wishes to market (this is in addition to compliance with the NPPR of the relevant member state).

UCITS post-Brexit: the marketing of funds

18 The effect of Chapter XI of UCITS IV is that, in order to bring itself within the passporting provisions, a UCITS fund must be domiciled in the EU and managed by an EU management company. It follows that, in the event of a cessation of EU membership without any other arrangements being in place, Gibraltar established UCTIS funds would

no longer be EU domiciled and Gibraltar management companies would not constitute authorised management companies. Therefore, such funds would fall outside the scope of the applicable passporting provisions, be categorised as AIFs and could only be marketed to professional investors in the EU pursuant to the article 42 regime under AIFMD. Similarly, an EU established and managed UCTIS would no longer have automatic access to the Gibraltar market and would have to comply with the Gibraltar NPPR.

AIFMs post-Brexit: marketing, management and depositories

(a) Marketing

19 Chapter VI of the AIFMD (articles 31 to 33) sets out the rights of EU AIFMs to market and manage EU AIFs in the Union. Chapter VII (articles 34 to 42) contains specific rules in relation to third countries.

20 As to Chapter VI, this contains provisions relating to the marketing of units or shares of EU AIFs in the home member state of the AIFM (article 31), the marketing of units or shares of EU AIFs in Member States other than in the home member state of the AIFM (article 32) and conditions for managing EU AIFs established in other member states. In terms of distribution (article 33). Article 32 thus represents the high-water mark of the passporting regime. Article 32(9) provides for such marketing to be directed only to professional investors.

21 In contrast, the provisions of Chapter VII address the various permutations of third country involvement, i.e. where the AIFM is not authorised in the EU or the AIF is not domiciled in the EU. Thus, for example, the position where an EU AIFM is marketing a non-EU AIF in Gibraltar without a passport is governed by the provisions of article 36.

22 Rather at the other extreme from the article 32 passporting regime is the article 42 regime (which forms part of Chapter VII). This contains provisions for the marketing in a member state without a passport of AIFs managed by a non-EU AIFM. The requirements of article 42 include that:

(1) The non-EU AIFM complies with articles 22, 23 and 24 in respect of each AIF marketed by it pursuant to article 42 and with articles 26 to 30 where an AIF marketed by it pursuant to article 42 falls within the scope of article 26(1);

(2) Appropriate cooperation arrangements are in place between the regulatory authorities of the member states where the AIFs are marketed and the authorities of the third country where the non-EU AIFM is established;

(3) The third country where the non-EU AIFM or the non-EU AIF is established is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force (on Money Laundering) (FATF).

23 It follows that, in the event of a cessation of EU membership without any other arrangements being in place, a Gibraltar AIFM, not being an EU AIFM would no longer be able to take advantage of the article 32 passporting regime. Gibraltar AIFMs, as third country firms, would need to comply with requirements imposed by article 42 in addition to those imposed by any relevant NPPRs. This presupposes the existence of appropriate cooperation arrangements between the regulatory authorities of the member states where the AIFs are marketed and the Gibraltar FSC.

24 Similarly, the marketing of non-EU AIFs in Gibraltar by EU AIFMs would no longer be subject to the regime imposed by article 36 but would also be governed by the article 42 regime.

25 The AIFMD does make provision for the potential extension in the future of the passport, currently reserved to EU AIFMs and AIFs. However, from the perspective of any non-EU country seeking to acquire passport rights, the assessment procedures adopted by ESMA for the purpose of determining whether it should recommend access to third country AIFMs are detailed and time-consuming.

26 For each country, ESMA must assess whether there are significant obstacles regarding investor protection, competition, market disruption and the monitoring of systemic risk which would impede the application of the AIFMD passport.

27 ESMA published its first set of advice on the application of the passport to six non-EU countries (Guernsey, Hong Kong, Jersey, Switzerland, Singapore and the US) in July 2015. The Commission subsequently asked ESMA to assess a further six countries (Australia, Bermuda, Canada, Cayman Islands, Japan and the Isle of Man) and to provide more details on the capacity of non-EU supervisory authorities and their track record in ensuring effective enforcement, including those non-EU countries which ESMA looked at in its first set of advice. The Commission also asked ESMA to provide data on the expected inflows of funds by type and size into the EU from the different non-EU countries.

28 ESMA published its further advice in July 2016.[4] That advice is currently under consideration by the European Commission, Parliament and Council. There is no reason to suppose that any departing member state would not have to take its turn in the queue of non-EU countries seeking application of the passport.

29 It is also intended that ESMA should report, in due course, giving its opinion on the functioning of the passporting regime under AIFMD and its advice on the termination of the existence of the NPPRs in each member state. Again, however, this process seems unlikely to be swift or straightforward.

(b) Management

30 Article 33 provides that EU AIFMs may, directly or by establishing a branch, manage EU AIFs established in another member state. It follows that, in the event of a cessation of EU membership without any other arrangements being in place, Gibraltar AIFMs would no longer have an automatic entitlement to manage AIFs established in other EU member states under article 33 (the applicable provisions instead being those in Chapter VI, specifically articles 37 and 41). Article 20 does, however, permit delegation of management activities to non-EU managers, provided certain minimal conditions are satisfied.

[4] www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries

(c) Depositaries

31 Article 21 requires EU AIFs to appoint a depositary established in the home member state of the AIF. For non-EU AIFs, the depositary may be domiciled in the home member state of the AIFM managing the AIF, the member state of reference of that AIFM or, subject to certain conditions, in the third country in which the AIF is established.

The special position of Gibraltar: might Brexit provide opportunities?

32 The comments which follow are from the perspective of a non-Gibraltar lawyer:

(1) As can be seen from the wide-ranging nature of the matters regulated under UCITS IV, many of the domestic regulatory consequences of the two directives do not have any necessary cross-border implications at all. There may various reasons why the Gibraltar FSC (or, for that matter, the FCA) might or might not find it advantageous to permit "creeping deharmonisation" but there is no obvious reason why cessation of EU membership without any other arrangements being in place should affect what has become (by its transposition) purely domestic regulation (it may have unintended consequences in the form of changing the effect of definition provisions but that is another story).

(2) The loss of passporting rights is clearly of great potential significance. The third country regimes which are presently available are not comprehensive. For example, the equivalence concept does not apply to the UCITS Directive, with the result that UCITS compliant funds from third countries cannot rely on passporting rights. Although the AIMFD contemplates that passporting may become available to non-EU AIFMs, the relevant provisions are complex and have yet to be commenced.

(3) This, though, raises the question of the extent of the existing use of passporting rights by Gibraltar UCITs or AIFMs. It has been suggested that a very significant proportion of funds registered in Gibraltar are not, in fact, distributed using the provisions of UCTIS IV or AIFMD but, rather, rely upon NPPRs. A loss of passporting rights might, therefore, be less significant to Gibraltar than to the UK not least because a very significant market for Gibraltar, the UK itself, will not be an EU member state.

(4) There is also a balance to be struck between the aspirations of, on the one hand, consumers and other investors and, on the other, those of the investment management industry. Reference has already been made to the perceived attractiveness to investors of UCITS and AIFs by virtue of the relative robustness of their regulation. Conversely, however, it has been suggested that certain Gibraltar based funds have in the past moved away from Gibraltar specifically to avoid having to comply with AIFMD. Logically, this must pose a regulatory challenge but also a potential opportunity: the availability of a regulatory regime which is sufficiently robust to reassure investors but sufficiently flexible to entice the investment management industry.

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