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INTRODUCTION

Welcome again to our latest edition of *Global Trustee and Fiduciary Services News and Views*, which captures content we know will be of strategic interest to you. For instance, you may be asking, is the regulatory implementation agenda finally slowing down? Is it now time to expend valuable time and resource to focus on broader global regulatory themes, soon to enter centre stage, and the opportunities or challenges they might provide?

Well, MiFID II continues to hurtle towards its implementation deadline, which is now less than six months away. So we couldn't have an edition that didn't look at implementation issues, this time in the Netherlands. There are still many unanswered questions for practitioners.

There are other topics already on the regulatory horizon – and these also deserve some airtime.

The Capital Markets Union (CMU): mid-term review

If you haven't paid the CMU Action Plan much attention yet, given your other more immediate priorities, then now is the time to take a look. Through the CMU mid-term review, the EU Commission aims to track progress of the CMU Action Plan, reframe actions in light of work undertaken so far and evolving market circumstances, and consider adding new complementary measures to the CMU Action Plan to tackle key challenges.

The Commission's Consultation Paper invites suggestions on measures that focus on delivering the overarching policy goals of the CMU:

1. Financing for innovation, startups and non-listed companies.
2. Making it easier for companies to enter and raise capital on public markets.
3. Investing for long-term, infrastructure and sustainable investment.
4. Fostering retail investment and innovation.
5. Strengthening banking capacity to support the wider economy.
6. Facilitating cross-border investment.

Most recently, work has begun to reach finalisation, with amendments to the Prospectus Directive (with the implementation of a Regulation) and with work to help improve the operation of venture capital funds. Our lead article considers for asset managers opportunities, reflections and engagement arising from the CMU mid-term review. This initiative will continue to evolve with further proposals to be published in June.

But what other topics are on people's minds?

The UK's decision to exit the EU, which is currently unfolding, is still of interest to many, not just those based in the UK. Included in this edition is an article that sets the scene and identifies topics for consideration, as asset managers continue to look at their options. Most recently, and also worth reviewing, is an Opinion from ESMA (ESMA42-110-433) setting out general principles aimed at helping market participants wishing to relocate from the UK to the EU.

We are still waiting for the UK's FCA to reveal its proposals for a Senior Managers and Certification Regime, and, in terms of this particular trend for senior management accountability on a global level, the Hong Kong regulator will shortly have its own regime in place — The Manager-in-Charge Regime. Our article covering this topic addresses what the Hong Kong Securities and Futures Commission-licensed corporations need to do to make sure they will be.

Unlocking innovation

Regulators globally have been discussing the potential benefits and concerns for FinTech and RegTech solutions to assist in the effective compliance of regulation. Two areas utilising such solutions for asset managers involve the continuing evolution of robo-advice and efficiencies to be gained for purposes of know-your-client (KYC) requirements.

This edition focuses on developments in the US, where robo-advisers have historically been more prevalent, but other jurisdictions are also picking up on this theme. However, in a bid to keep up with the growth of online financial services offerings, the SFC recently released a consultation on proposals to regulate online distribution and advisory platforms for investors. The regulator is proposing to introduce guidelines for online order execution, distribution and advisory services. The proposed guidelines also cover robo-advice, an area that until now has not been directly targeted by regulation in Hong Kong.

Additionally we also consider how distributed ledger technology can be used to lower KYC costs.

We would like to thank all our external contributors for their time and insights: we are grateful to them for sharing their knowledge and experience with us and our readership.

In keeping with previous editions, we hope you continue to enjoy Global Trustee and Fiduciary Services News and Views and invite you to contact our Regulatory Services team (see our contact details at the back) with any questions you might have or interests to learn more about any regulatory matters not covered in this edition.

CMU AT MIDTERM: AN OPPORTUNITY FOR ASSET MANAGEMENT REFLECTION AND ENGAGEMENT

As the European Commission is in the midst of its midterm review of the Capital Markets Union (CMU), it is a timely moment for all European capital markets participants to reflect on the CMU's trajectory and what it can still achieve. This is especially true of asset managers, as the CMU is in many respects an important validation of the critical role the industry plays in growth and capital formation. Of course, Brexit has complicated matters considerably (as the Commission acknowledges). However, as discussed in more detail below, the CMU's policy framework underscores the central role London currently plays in the European financial ecosystem and suggests that the CMU's successful implementation will require strong linkages between the UK and EU27 to remain.

Overview

While the promise of the CMU currently remains largely unfulfilled, and although it has certainly been complicated by Brexit, the European Commission's continuing commitment to the project nevertheless offers a variety of opportunities (and challenges) for the asset management industry.

The CMU has always been presented as both a comprehensive aspiration – increased capital market integration – and a diverse series of policy proposals and initiatives intended to support various pillars of that integration. Also, asset management was always meant to play an important role in the CMU and, as a result, most of the CMU workstreams have the potential to increase the industry's EU footprint either directly or indirectly. As discussed in more detail below, this primarily takes the form of widening and unlocking investment flows from the retail and professional investor pools (indirect) and then trying to channel them to asset management in specific ways (direct).

Broadly, the asset management-specific initiatives focus on:

- Expanding the EU venture capital market.
- Minimising the impediments to cross-border management and the marketing of investment funds.
- Creating new vehicles to manage, such as the pan-EU pension product.
- Supporting increased investment in European Long-term Investment Funds (ELTIFs) by adjusting Solvency II risk charges.

However, the CMU appears to have a potential indirect impact on asset management in a wide variety of ways, including in terms of investment opportunities by:

- **Strengthening public securities offerings and private placements.**
- **Creating a new category of "high-quality" securitisations.**
- **Improving the covered and corporate bond markets.**
- **Developing increased uniformity on crowdfunding rules.**
- **Addressing national discrepancies on business insolvency, securities ownership, and taxation.**

Likewise, the CMU workstreams in FinTech and its focus on improving retail access to financial services indicate a supportiveness of many of the asset management industry's innovations, such as robo-advice.

Asset management was always meant to play an important role in the CMU and, as a result, most of the CMU work streams have the potential to increase the industry's EU footprint either directly or indirectly.

Furthermore, the CMU's pro-growth agenda incorporates a review of post-crisis regulation to rationalise market stabilisation efforts. This review has identified streamlining reporting requirements – such as those under PRIIPs, MIFID II, UCITS, etc. – as a likely initiative that will benefit many asset managers.

Mixed success

In certain areas, the CMU has achieved some successes that may have been surprising at the outset. Specifically, the EU institutions have taken some steps to intervene in areas that have traditionally been the province of domestic law but that are necessarily interconnected with capital market formation. For example, the Commission proposed a corporate tax offset allowance for equity issuance to address the "debt-equity" bias whereby companies seek debt over equity financing because of perceived tax benefits. Also, the Commission has issued proposed insolvency rules for preventative restructuring frameworks. Recently, it published a consultation to assess a potential framework for European personal pensions, which would try to facilitate the development of cross-border products that have historically been distributed exclusively within national borders.

However, inter-institutional inefficiencies have stalled many Commission initiatives in trilogue discussions where, in many instances, Parliament and Council have become roadblocks. For example, the Commission proposed a regulatory framework for "high-quality" securitisations with reduced capital requirements simultaneously with the release of the wider CMU action plan in Q3 2015. But, this regulation has gone through complex trilogue negotiations, as Parliament has fundamental objections to the underlying rationale of the regulation, specifically expanding Europe's securitisation market. Similarly ambitious agenda items, such as reducing credit-risk capital reductions for infrastructure exposure and reducing capital requirements for credit unions more broadly, also await approval by Parliament and Council.

A pivot to address apathy and disruption

Such uneven progress has been exacerbated by the surprising result of the UK's referendum and the resulting diversion of attention and resources to address Brexit, along with a continuingly expansive post-crisis regulatory agenda. Furthermore, firms appear to be so busy grappling with the accumulated compliance and operational burdens of existing and upcoming regulatory requirements, such as MIFID II, that they have failed to think strategically about the potential benefits of the CMU and how to best engage with the EU institutions.

To address the accumulated concerns of Brexit, an uneven rollout, and tension within the EU institutions, the Commission published a communication in September 2016 reaffirming its commitment to the CMU. While fundamentally affirming the assumed trajectory, the communication also signalled an important pivot with the intent to re-energise the CMU agenda. The pivot focuses explicitly on three new priority areas: sustainable finance, FinTech and supervisory convergence by the European Supervisory Authorities (ESAs). However, it also obliquely referenced Brexit, which will be the critical subtext to whether or not the CMU as initially envisioned is achievable.

While every aspect of the CMU, especially the three new areas of focus, will be challenged by the UK's withdrawal from the EU, the CMU framework provides a fairly comprehensive opportunity to maintain links with the UK after it leaves the EU post-Brexit concerning market activities where the EU is most dependent on the UK's investors, infrastructure and intermediaries, for example. Whether or not this opportunity will be seized is another matter.

Wooing European Parliament

The CMU's progress reveals an enthusiasm gap between the Commission and the other two EU governing bodies, especially Parliament. There appears to be a philosophical divide as to the benefits and costs of more robust capital markets, primarily the revitalisation of activities that pose investor protection concerns. While the EU securitisation market performed much better than in the US (where it was the main contributor to the financial crisis), the European public's aversion appears to have influenced Parliament's response to the proposed regulations. While not backing down either from the securitisation package or from the general principle that the balance between bank and capital market finance needs to be recalibrated, the Commission appears intent on demonstrating that growing capital markets can facilitate socially worthwhile ends.

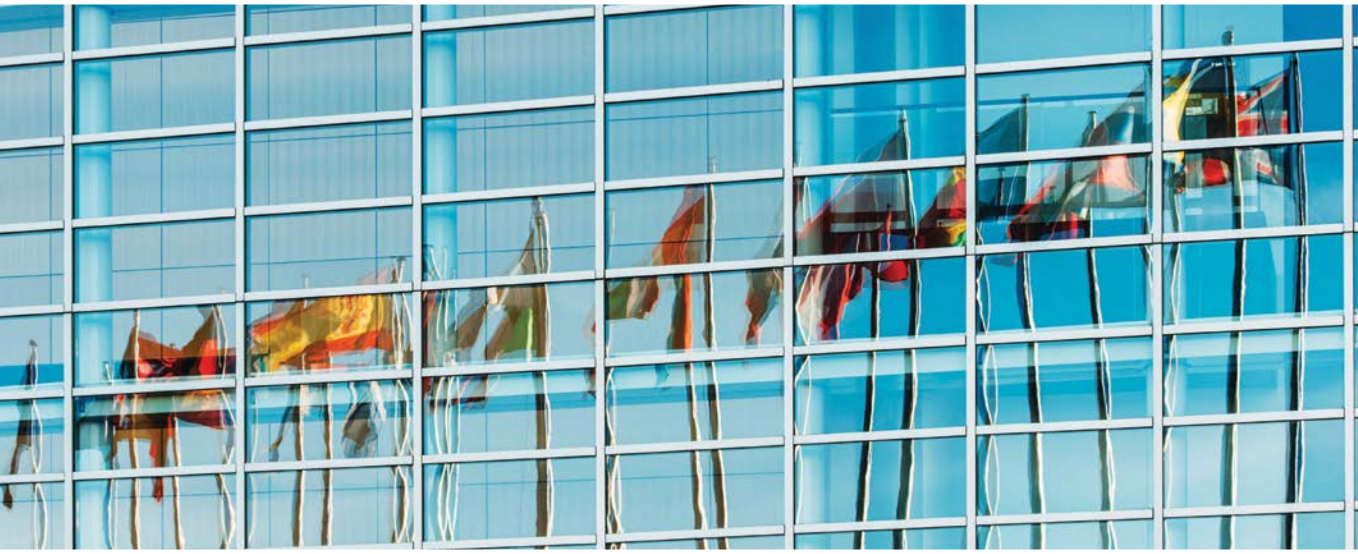
Specifically, the Commission will be convening a high-level group to come up with an operationally feasible sustainable finance agenda. At this stage, it is unclear what the group's findings will be and whether it will advocate any EU-wide regulation of the market, such as creating a regime for EU green bonds.

The EC's FinTech workstream is further along, as it recently published a consultation seeking input on investor-protection provisions, the impact of regulatory divergence for crowd-funding and other areas and cross-border impediments to technological access (cloud computing), among others. The Commission seems especially focused on whether fintech activity should be regulated as a discrete area or on similar terms to other entities that perform like services. The enthusiasm stems in large part from an understanding that digital solutions can facilitate integration by reducing the meaningfulness of physical distance, and can support some of the CMU's other specific agendas such as better matching investors and investment opportunities across the EU.

Venture-capital package

The Commission has targeted venture capital (VC) as an under-utilised source of funding and expertise for firms looking for equity investment. VC can provide companies with deeper capital pools than angel investors can provide (although the CMU also looks to increase the profile of angel investors) and can also leverage their market experience on behalf of their acquisitions. The Commission seems to view the interests of VC firms and their investments as broadly aligned, as the various exit ramps for VC investors are typically scenarios where the other underlying shareholders will benefit — such as through an IPO or private sale.

As in other areas, the Commission views the EU VC industry as too parochial, whereby firms tend to have a limited geographic reach in terms of inbound and outbound investment. When compared with the US, this results in VC funds that are much smaller and unable to achieve the same economies of scale.



EuVECAs

So far, the flagship CMU VC initiative has been a proposed regulation amending the European Venture Capital Funds (EuVECA) framework with the intent of improving the profile of VC funds more broadly. The EuVECA Regulation was designed to create a well known VC vehicle that would attract pan-European investment and that could be marketed on a cross-border basis. Initially, it was designed to give smaller VC managers outside of the AIFMD's scope an opportunity to nonetheless access an equivalent passport. In addition, EuVECAs enjoy some structural advantages as the regulation allows them to market to a wider client pool than typical AIFs by including certain high-net-worth individuals and subjects them to lighter regulatory requirements (i.e. an absence of depositary requirements).

However, the proposed regulation seeks to address some of the limitations of the original regime as identified by the Commission. While allowing smaller AIF managers to enjoy a passport is still a core element of EuVECA, the Commission is proposing to extend EuVECA eligibility to all AIFMs regardless of size and whether they lie within the AIFMD's scope. While such managers obviously already enjoy a passport, such an extension would allow registered AIFMs to enjoy lighter requirements for their VC vehicles and to market to a subset of retail investors. The inclusion of these larger managers is intended to incentivise their wider involvement in VC, thereby attracting the strongest firms to the market and bringing better economies of scale.

Furthermore, the Commission believes that the criteria for eligible investments were too narrowly drawn and that a wider range of companies, such as those with up to 499 employees and those listed on small- and medium-sized enterprises (SME) growth markets, should benefit from the VC funding that EuVECAs can provide.

Fund-of-funds support and tax incentives

Another major CMU initiative is the pan-European VC fund-of-funds programme. Here, the EU is putting its money where its mouth is by authorising the European Investment Fund (EIF) to make investments in qualifying fund-of-funds with a target amount of EUR300 million. The primary focus will be VC funds that can credibly grow past the AIFMD threshold of EUR500 million in a short period of time, as these are the vehicles that can provide the desired economies of scale and cross-border reach. The funds must be established in the EU, managed by an EU entity and have at least 50% of its investments in EU companies.

Finally, the CMU is also exploring how to best apply tax incentives for VC firms and angel investors, specifically for longer-term investments that have higher risk-reward profiles. A number of Member States are already using targeted incentives and the Commission has requested a study that will look at national best practices, among other areas.

Addressing cross-border impediments for investment funds

Improving the cross-border reach of the main EU investment fund regimes (UCITS and AIFMD) is clearly a top CMU priority, as the issue is central to two separate workstreams: the broader initiative to address impediments to cross-border capital flows and the more focused work of ameliorating cross-border distribution of funds. The Commission notes that while there is widespread usage of the passport, whereby 80% of UCITS funds are marketed cross-border and 40% of AIFs, it is still geographically limited as 33% are only marketed in one host state and another 33% are marketed in no more than four Member States.

While acknowledging there may be broader issues restraining cross-border activity – such as concentrated fund distribution channels in individual Member States, cultural preferences, etc. – the Commission views the time and costs spent navigating regulatory divergence as a key barrier. Like with its efforts to expand the reach of VC funds, the Commission is concerned that the multitude of smaller, more regionally focused funds means that capital is not being efficiently allocated, certain regions are cut off from deeper investor pools and the funds are unable to benefit from economies of scale.

While some of the regulatory and legal concerns will probably only be addressed through national law, many of these issues can be dealt with through amendments to EU directives. Despite the relative comprehensiveness of EU rules, there are a few areas where the discretion enjoyed by Member States has resulted in unhelpful divergence. Given the upcoming AIFMD and UCITS reviews, it is possible that the CMU's focus on this area will inform the conclusions of such reviews and yield regulatory proposals.

The main areas that the Commission is looking at include:

- Different marketing communication requirements and divergent standards on review and oversight of communication content.
- Varying administrative requirements for funds marketed to retail investors, such as requiring that facilities for redeeming, subscribing and receiving payments, which need to be based in the local jurisdiction.
- Regulatory fees applied when notifications are made to market cross-border.

The Commission observes that while the cumulative costs may not be very much in absolute terms, the research effort expended and regulatory uncertainty acts as a significant impediment. Also, the EU could conceivably take the lead in further defining the definitional parameters of marketing vs pre-marketing vs reverse solicitation, but it appears that this will be left to national legislatures.

The proposed EuVECA amendments, already discussed above, provides a potential template, as the proposed rules prohibit host-Member State authorities from imposing any additional requirements or administrative arrangements for marketing nor require pre-approval by the host State of marketing communications.

Outside regulatory divergence, the Commission has also identified withholding-tax practices as another important impediment. Although bilateral tax treaties attempt to address double-taxation of cross-border investment by the provision of tax refunds, unfortunately, investors tend to have difficulty securing these refunds due to the complex documentation requirements that are difficult to complete and demand resources to understand diverging Member State rules.

Currently, the Commission is attempting to address these complications with a collection of best practices, with the expectation that each Member State would then be expected to make commitments around the implementation of these best practices. It will also use the best practices to inform a more comprehensive code of conduct addressing efficient withholding-tax-relief refund procedures.

Given Member State prerogatives on taxation, such voluntary initiatives are probably the most politically feasible approach.

Focus on supervisory, but less on regulatory, convergence

So far, a number of themes and tensions have emerged during the CMU's progression. The most important has been the debate on how to best craft regulatory coherence. While perhaps not a thesis that everyone would agree with, the Commission has always advocated the idea that capital markets are strengthened by common rules across the market. The CMU is premised on the idea that a top-down political initiative can shape capital markets in a way that market forces in isolation could not, and continues to explore whether common EU rules would be preferable to Member State divergences.

Such an argument is certainly supported by the example of the US, whose asset management sector and securities markets expanded dramatically when divergent state rules were overridden by common federal statutes. The 1930s and early '40s saw the US create its modern capital markets structure, with comprehensive rules for securities offerings, trading, brokerage, mutual and hedge funds, and asset management more broadly.

While political realities and the scale of regulatory amendments precluded such an ambitious federalisation of EU capital market regulation, nonetheless the CMU was proposed with the intent of exploring increased EU regulation (while diminishing Member State discretion). So far, though, the record has been mixed. In a number of key areas, the Commission has pulled its punches and concluded that voluntary and private sector measures built on best practices would be better than new regulation. Recent examples include approaches to covered bonds and private placements.

Of course, with as large and complex a project as the CMU, the picture is not so simple as a uniform decision to pull back from common regulation. There is a high chance that the CMU workstreams concerning barriers to capital flows and distribution of funds will lead to amendments of the AIFMD and UCITS, as discussed above. Likewise, significant regulatory changes to prospectus rules, securitisation and VC vehicles have already been proposed and are at various stages of the EU legislative process.

Even more significantly, the Commission is looking to expand the powers of the ESAs. A recent consultation explores changing the ESAs structure and decision-making processes to diminish the role of Member State regulators – who may have national agendas to advance. Also, the Commission suggests increasing the areas that the ESAs enjoy direct oversight. Currently, the ESAs regulate credit-rating agencies and trade repositories directly with additional authorisation powers (especially in terms of third-country equivalence) across other regulations. However, the Commission would like to see the ESAs enjoy comparable authority over pan-EU investment fund regimes, as well as a wider range of financial market infrastructure.

Doing so would go a long way to creating increased regulatory cohesion without whole-scale changes to existing EU law. While EU regulation covers more and more financial market activity, and while more and more of such regulation is directly applicable, Member States have wide discretion around enforcement priorities. Given the scale of post-crisis regulation, many regulators are selecting certain areas to focus on at the expense of others.

To take one example, the UK's Financial Conduct Authority (FCA) continues to focus on MiFID reporting failures while so far refraining from fining firms for their widespread problems under EMIR (both in terms of transaction reporting and in terms of other areas). It is not unsurprising that the only entity to be fined under EMIR so far has been DTCC Derivatives Repository Limited, which, as a trade repository, is directly regulated by the European Securities and Markets Authority (ESMA). Likewise, it is widely known that national regulators within the EU will wait awhile before enforcing the new EMIR margin rules. While there are broader reasons for such restraint – in many jurisdictions firms have been formally given an extended implementation timeline – it underscores that regulators frequently make strategic decisions as to how EU regulation is enforced.

Such selectivity can result in uneven application of regulation across borders, thereby creating variable, sometimes unknown costs to business, which can be an impediment to cross-border investment. The EU clearly feels that this problem is especially acute in the investment fund space.

Brexit

The acknowledged fragility of the EU's capital markets, and the current reliance on London as a capital markets ecosystem, argues for a more comprehensive assessment of the challenges posed by Brexit for the CMU than has currently been attempted. The Commission has already referenced Brexit in various CMU communications to support the idea that the CMU is needed now more than ever, as tighter integration on the continent will be necessary. But, the CMU can also be a mechanism to advance market integration in the interests of both the UK and the EU27, despite Brexit. The fact that this has not been an area of focus for firms, the UK government and the EU is a potentially missed opportunity that can still be seized.

Other than amendments to the prospectus rules, none of the other major CMU initiatives are close to being finalised. Whether these take the form of concrete regulations or less immediately applicable reports and horizon-scanning analysis, they all present an opportunity to expand the potential for market access through equivalence. For example, UK VC funds benefiting from designation as EuVECAs could still benefit European investors by

> **The Commission has already referenced Brexit in various CMU communications to support the idea that the CMU is needed now more than ever. But the CMU can also be a mechanism to advance market integration in the interests of both the UK and the EU27.**

continued access either through equivalence or grandfathering provisions. Likewise, preventing UK firms from using the passporting opportunities afforded by the prospectus regulation or benefiting from the STS securitisation designation would further limit investment opportunities for continental investors.[1]

The CMU presents a unique opportunity because it is comprehensively ambitious, is largely unformed and covers an area where both the UK and the EU have acknowledged the need for increased integration. While there are a few opportunities to actually embed equivalence provisions in regulations that have yet to be formally proposed or are in trilogue negotiations, the biggest opportunity lies in shaping the debate in the various reports and working groups developed in ways conducive to advancing the CMU agenda. For example, the EC's efforts studying the impact of fragmented markets within Europe for crowd-funding, personal pensions, etc., all present opportunities to look at the toll that separation of the UK and the EU capital markets will exact on both jurisdictions. Likewise, they provide a potential vehicle to help advocate a robust equivalence framework when the rule-making process begins.

In addition, capital markets considerations provide strong justification for a bespoke agreement that would efficiently preserve much of their current integration and scale. As CMU's multi-pronged, multi-track nature demonstrates, capital markets are arguably harder to integrate than certain other types of retail and wholesale markets (such as derivatives trading). Consequently, they are more likely to be negatively affected by the current framework of limited equivalence on a provision-by-provision basis within regulations. A bespoke agreement providing for market access on a comprehensive basis, justified by exact regulatory alignment, would be an arguably more effective way to ensure that any market split is not due to gaps in market access.

To underscore the potential for the CMU to act as a bridge during Brexit, all of the recent CMU areas of focus play to UK strengths. The UK has proven to be a leader in sustainable finance, especially led by the Bank of England's review of the impact of climate-change risk on its statutory activities. Likewise, the FCA has been a world leader in regulatory support of FinTech through its innovation hub and regulatory sand box. Lastly, the UK could possibly negotiate acceptance of ESMA supervision of certain activities as a means to obtain market access after Brexit, which could be especially valuable if ESMA's remit were to be expanded in the asset management space.

Conclusion

While there has been an impressive amount initiated by the Commission, virtually the entirety of the CMU agenda has yet to be finalised. This means that asset managers have an important opportunity to shape the debate, both in the narrower sense of specific CMU workstreams and more broadly in terms of how capital markets considerations should factor into the posture of UK and EU negotiators.

Firms certainly have the ability to respond to the wide range of consultations and regulatory proposals that are currently, or will soon be, opened, and all have opportunities to engage national regulators and the EU institutions on those initiatives still stuck in negotiations. More broadly, firms should take a step back from the deluge of near-term compliance and implementation challenges they are currently grappling with to recognise the CMU's enduring potential and their power to change its direction. Especially since EU capital markets would be dramatically strengthened if the CMU could be used as a mechanism for continued access in both directions after Brexit. It is a potentially valuable bargaining chip that the UK government should be mindful of as it enters into negotiations, and asset managers should be proactive in highlighting the importance of capital markets issues.

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HONG KONG MANAGER-IN-CHARGE REGIME: WHAT SFC-LICENSED CORPORATIONS NEED TO DO

On 16 December 2016, the Hong Kong Securities and Futures Commission (SFC) introduced its new Manager-In-Charge of Core Functions (MIC) regime, with details set out in its Circular Regarding Measures for Augmenting the Accountability of Senior Management (Circular)[1] and a related series of 41 Frequently Asked Questions (FAQs).[2]

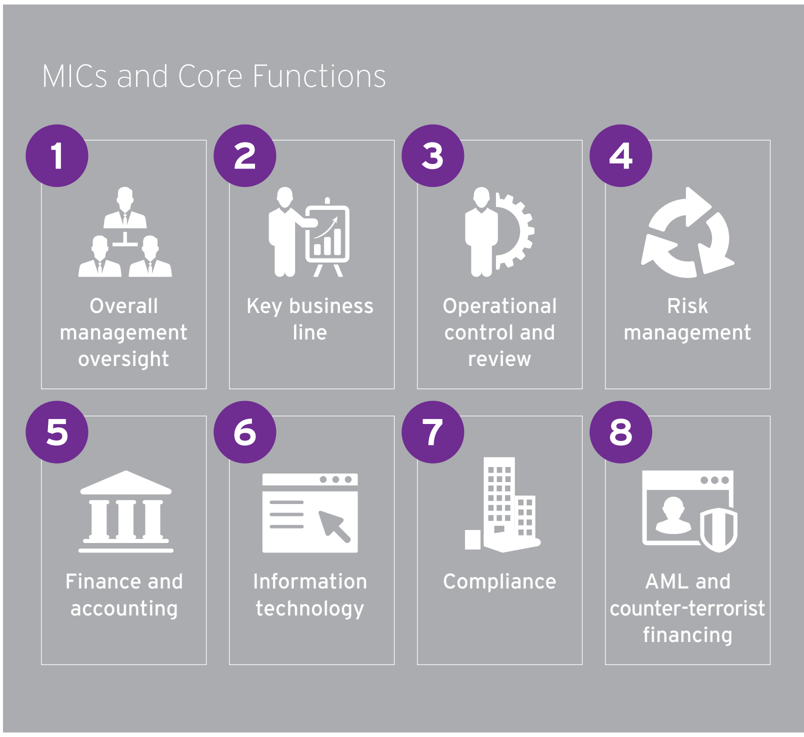
The MIC regime is a change to the way in which the SFC seeks to exercise regulatory oversight of licensed corporations. It seeks to add clarity as to which individuals, by reference to their roles and responsibilities, qualify as senior management of a licensed corporation in the eyes of the SFC. The consequences being that a person involved in the management of the business of a licensed corporation is considered to be a regulated person over whom the SFC may exercise its disciplinary powers, regardless of whether such person is actually licensed with the SFC.

For licensed corporations that are part of a wider group, the MIC regime may also require licensed corporations to identify and report information about individuals from other group companies (within or outside Hong Kong) who qualify as an MIC even though they are not licensed by the SFC.

The MIC regime will impose new reporting obligations on all licensed corporations and will require ongoing reporting of information about people in middle- and back-office roles who may not be licensed with the SFC. We explore requirements of the proposed MIC regime below in more detail.

Overview of the MIC regime

In the Circular, the SFC sets out its view that the senior management of a licensed corporation includes MICs, in addition to directors and responsible officers (ROs). An MIC is an individual appointed by a licensed corporation to be principally responsible, either alone or with others, for managing any of the "Core Functions" of the licensed corporation. There are eight Core Functions, as shown in the diagram opposite.



Licensed corporations will need to designate an individual as the MIC for each Core Function, and will need to report information about its MICs, and any changes in this information, to the SFC.

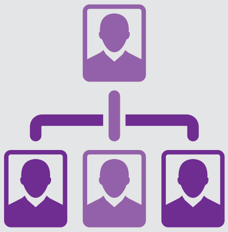
The Circular identifies several reasons for the SFC to introduce the MIC regime. The MIC regime is intended to ensure that persons who are MICs for the overall management oversight and key business-line functions of a licensed corporation become ROs of the licensed corporation, if they are not already ROs. The MIC regime is also intended to promote awareness of the responsibilities, accountability and regulatory obligations of the individuals identified as MICs. Although not expressed in the Circular, over time the MIC regime is also likely to increase the

18 April 2017

SFC accepts MIC information and management organisational charts from all licensed corporations and new corporate license applications.

17 July 2017

Deadline set for licensed corporations to submit MIC information and management organisational charts.



16 October 2017

Deadline set to submit applications to the SFC for MICs who need to be approved as ROs.

localisation of Core Functions in Hong Kong for licensed corporations that are part of a wider international group.

The key dates for implementation of the MIC regime are captured in the graphic above, and a more detailed timeline is attached at the end of this article.

Summary of actions required

The actions each licensed corporation needs to take include the following.

By 17 July 2017, each licensed corporation should:

- Identify the individuals who are or will be MICs, brief them on the MIC regime and their obligations, and get their acknowledgement of their appointment as MICs.
- Prepare descriptions of the roles of each MIC and a structure chart for the licensed corporation, including each MIC's reporting lines.
- Prepare a formal board paper (a management structure paper) setting out the management structure of the licensed corporation, the roles, responsibilities, accountability, and reporting lines of its senior management personnel.
- Prepare relevant SFC forms.
- Have the board of directors approve the management structure paper, the appointment of the MICs, the roles of each MIC, the structure chart and reporting lines, and the submission of information about the MICs to the SFC.
- Submit information about the MICs to the SFC, including the structure chart and completed SFC forms.
- And put in place a compliance process to monitor changes relating to MICs and to report such changes to the SFC.

By 16 October 2017, each licensed corporation should:

- If the MIC responsible for overall management oversight or a key business line is not currently an RO, prepare and submit an application to the SFC for that person to become an RO.

More on the MIC regime

Identifying MICs

The scope of the Core Functions is described in detail within the Circular. A licensed corporation must identify and appoint an individual (either alone or with others) to take up principal responsibility for managing each Core Function. One person can be an MIC for more than one Core Function. An MIC may be located in or outside Hong Kong. An MIC may also be an RO and/or a director of the licensed corporation or an employee of a group company. The SFC also anticipates that in some circumstances two or more people may be appointed on a joint basis as MICs for a single Core Function.

The MIC regime is a change to the way in which the SFC seeks to exercise regulatory oversight of licensed corporations.

The SFC expects an MIC to have authority (apparent or actual) over the Core Function(s) for which the MIC is responsible. The SFC expects an individual who is appointed as an MIC to have:

- A position in the licensed corporation that is of sufficient authority to enable the individual to exert a significant influence of the conduct of the Core Function.
- Authority to make decisions (e.g. assume business risk within preset parameters or limits) for that Core Function.
- Authority to allocate resources or incur expenditures in connection with the particular department, division or functional unit carrying on the Core Function.
- And authority to represent a particular department, division or functional unit carrying on that Core Function, e.g. at senior management meetings or in meetings with outside parties.

Identifying MICs of a licensed corporation within an international organisation with multiple reporting lines can present some challenges. Where a Core Function involves a local, regional and global reporting structure, the question to be considered is to what extent the Hong Kong-based individual has sufficient day-to-day authority in the execution of such function. A lack of authority by a locally based individual is likely to result in having to trace the authority up the chain for the purposes of identifying the relevant MIC.

The SFC has also indicated that it expects licensed corporations to be satisfied that MICs are "fit and proper" to act as MICs for the relevant Core Functions.

In practice, that is likely to mean the individual has sufficient knowledge, skill and expertise to assume the authority and responsibility of a senior manager in respect of the relevant Core Function and has not been subject to a disciplinary, regulatory or other sanction that adversely affects his or her ability to perform the relevant Core Function.

Once an individual has been identified, the licensed corporation will need to obtain acknowledgement from the individual of his or her appointment as an MIC.

If an individual will be appointed as the MIC responsible for either the overall management oversight or a key business-line function, then the licensed corporation will need to apply for approval of the individual as an RO, if he or she is not currently an RO. For this purpose, the FAQs indicate that the SFC will take into account industry experience in operations, compliance and other back-office roles, in addition to direct experience in regulated activities such as asset management or dealing in or advising on securities.

Whether an individual will be considered as exercising overall management oversight is likely to be determined by the extent to which such individual is responsible for directing and overseeing the effective management of the overall operations of a licensed corporation on a day-to-day basis.

The key responsibilities of such individual may include the development and implementation of business models, objectives and strategies, and the promotion of sound corporate governance practices. Hence an individual occupying the position of chief executive officer (or equivalent) is likely to be considered as exercising overall management oversight.

Whether an individual is likely to be considered as someone assuming responsibility for a licensed corporation's key business line will depend on the extent to which such individual is responsible for directing and overseeing one or more of the licensed corporation's regulated activities. An individual occupying the position of chief investment officer, head of equity or equivalent is likely to be considered as responsible for the key business-line function.

Personal liability of MICs

Pursuant to Part XI of the Securities and Futures Ordinance, the SFC's disciplinary powers extend to a regulated person.[3] The term "regulated person" means a person who is or at the relevant time was any of the following types of person:

- A licensed person (i.e. individual licensed representative of a licensed corporation).
- An RO of a licensed corporation.
- Or a person involved in the management of the business of a licensed corporation (regardless of whether he or she is licensed).

Where a licensed corporation is found guilty of misconduct that is attributable to any act or neglect on the part of an individual involved in such corporation's management, then such individual is also guilty of misconduct.

While there has been no change to the definition of "regulated person", the industry has tended to assume that the SFC's focus is on those individuals licensed by it as ROs or representatives rather than those individuals who, while not licensed, play a significant role in the licensed corporation's management.

The MIC regime does not therefore create any additional liabilities or give the SFC any additional enforcement powers. What it does, however, is clarify what roles or individuals should be regarded as part of the management of a licensed corporation and ensures that the SFC has additional information about licensed corporations and the individuals responsible for each of the Core Functions. It also imposes an obligation on licensed corporations to keep this information up to date.

> **"Identifying MICs of a licensed corporation within an international organisation with multiple reporting lines can present some challenges.**

The SFC does not approve or license MICs. However, an individual appointed as the MIC responsible for either the overall management oversight or a key business-line function is expected to be licensed as an RO of the licensed corporation.

Reviewing organisational structure, reporting lines

The MIC regime will require licensed corporations to review their organisational structure to ensure it reflects the Core Functions and the SFC's expectations of reporting lines of the MICs.

While the SFC does not mandate any particular structure, it generally expects that an MIC should:

- Report directly to either the board of directors of the licensed corporation or to the MIC who assumes the overall management oversight function.
- And be accountable for the performance or achievement of business objectives set by the board of directors of the licensed corporation or by the MIC who assumes the overall management oversight function.

Licensed corporations will need to consider whether current job descriptions and reporting lines are consistent with the MIC regime, and may need to revise their organisational structure accordingly. That may mean, for example, revising current job descriptions to give individuals sufficient authority to act as MICs and/or additional reporting lines to the board of directors of the licensed corporation or to the MIC who assumes the overall management oversight function. For international groups, it may also mean adding employees in Hong Kong to act as an MIC.

When reviewing its organisational structure, a licensed corporation should also keep in mind the segregation requirements under the Management, Supervision and Internal Control Guidelines, which require licensed corporations to segregate front office functions from back-office functions.[4]

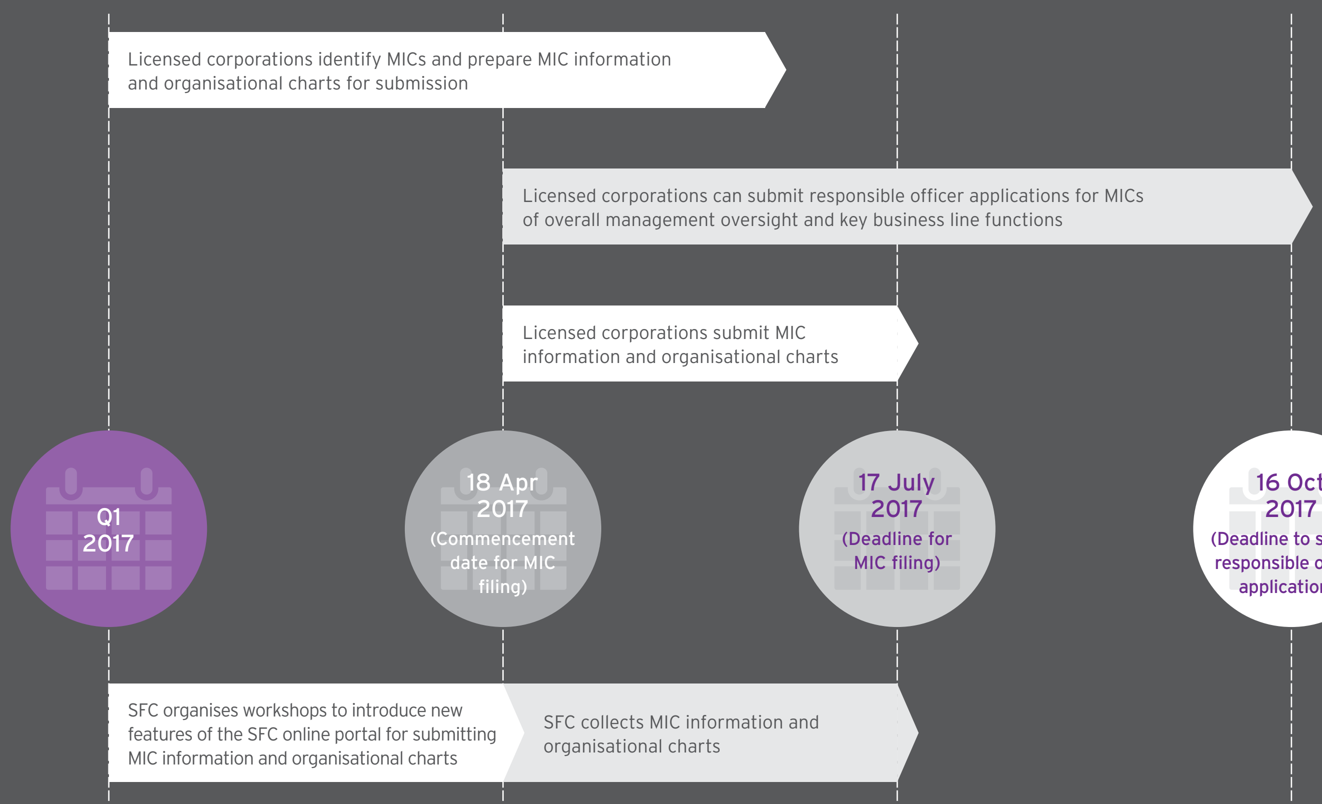
There is no need to change the job titles of individuals to match the Core Functions.

Ensuring board approval of MICs

Once a licensed corporation has identified its MICs and finalised its organisational chart, the Circular requires that the board of directors of the licensed corporation:

- Approve the management structure paper.
- Approve the organisational chart.
- Approve the appointment of the MICs.
- And ensure each MIC has acknowledged his or her appointment as an MIC and the Core Function(s) for which he or she is principally responsible.

The MIC Regime Timeline



Preparing SFC notification/application documents

The documents that a licensed corporation needs to submit to the SFC by 17 July 2017 include:

- Information about each MIC, in the form of Supplement 8A
- And an organisational structure chart [5]

If the individual identified as the MIC responsible for overall management oversight or a key business line is not currently an RO, the licensed corporation will need to prepare and submit an application to the SFC for that person to become an RO by 16 October 2017. The competency requirements for an RO are set out in the SFC's Guidelines on Competence.[6] The FAQs indicate that the SFC will take into account industry experience in operations, compliance and other back-office roles, in addition to direct experience in regulated activities such as asset management or dealing in or advising on securities.

Reflecting the MIC regime in internal documents and procedures

Licensed corporations will need to update their compliance manuals and policies to reflect the MIC regime.

Licensed corporations will also need to put in place a compliance process to monitor changes relating to MICs and to report such changes to the SFC.

Changes in the individuals who act as MICs for a core function and/or changes in organisational structure will also need to be approved by the board of directors of the licensed corporation.

Implementation timeline for the MIC regime

The impending deadline of 17 July 2017 by which existing licensed corporations must complete their MIC filing is fast approaching. The industry has had some seven months to prepare, and a failure to meet such deadline is likely to call into question the fitness and properness of an entity to remain licensed with the SFC. Any areas of uncertainty or ambiguity should be resolved in advance to enable a complete and accurate MIC filing to be made by the deadline. However, as in the case of many of its new regulatory initiatives, it is expected that the SFC will adopt a facilitative approach during the initial implementation stage, provided the regulatory filing deadline has been met.

Jeremy Lam
Partner
Deacons

1 See http://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/licensing/doc?refNo=16EC68, last accessed on 27 April 2017. Link here.

2 See http://www.sfc.hk/web/EN/faqs/intermediaries/licensing/manager-in-charge-regime.html, last accessed on 27 April 2017. Link here.

3 See http://www.sfc.hk/web/EN/pdf/laws/sfo/1/Ordinance/5%20of%202002.pdf, last downloaded on 27 April 2017. Link here.

4 See http://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/management,-supervision-and-internal-control-guidelines-for-persons-licensed/Management,%20Supervision%20and%20Internal%20Control%20Guidelines%20for%20Persons%20Licensed%20by%20or%20Registered%20with%20the%20Securities%20and%20Futures%20Commission.pdf, last downloaded on 27 April 2017. Link here.

5 The SFC has not mandated a specified form, which will vary depending on the circumstances of each licensed corporation.

6 See http://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guidelines-on-competence/Guidelines%20on%20Competence.pdf, last downloaded on 27 April 2017. Link here.

THE LIKELY IMPACT OF THE 23 JUNE EU REFERENDUM ON UK-BASED ASSET MANAGERS

While we have no clarity on what the post-Brexit picture will look like, we can now "set the scene" and identify key topics for consideration, as asset managers look at their options. If they have not already done so, asset managers must start making plans to adjust their business models and group structures. But what exactly are we looking at? And what should asset managers draw from it? This article takes a closer look.

The UK currently enjoys a position that it would never achieve again were it to exit and subsequently reapply for EU membership. This is evident from the chart opposite, which was published by the European Commission in a March publication.[1]

The current position is relatively attractive for UK-based asset managers, with full access to the EU Single Market and the use of passports under UCITS, the AIFMD and MiFID. Their ideal scenario would be to retain access to the Single Market and all these passports, but this is unlikely. The debate has now moved on for reasons explained below.

All seem to agree that some form of bespoke deal is needed. This does not simply arise from the UK's potential wish list but from the interconnectedness of the financial markets between the UK and the other European countries. And, of course, the UK remains an asset management hub. But, at this stage, we have no idea what the new deal for the UK will look like.

The UK government's white paper published on 30 March 2017[2]: Legislating for the UK's withdrawal from the European Union makes no mention of specific details – and in opening any negotiation, this may be expected. Certainly the financial services industry would hope that the government would pursue the best possible position for UK-based financial institutions and that the opening position should involve asking for full access, even if in the end there is some compromise reached.

The other side of the coin is, of course, what might be the EU's position. Aside from the European Commission's March "Way Forward" document,[3] the European Council published guidelines on 29 April[4] regarding the overall positions and principles that the EU will pursue through the negotiation – but, as one would expect, these are relatively high level.

So it is impossible at this stage to predict how the politics will work through. In any political debate, there is a risk that we, at best, lose the intricacies of detailed issues and, at worst, sometimes politicians reach an outcome detached from them. So the worst-case scenario is that we could be looking at some form of disorderly exit with no special advantageous position going forwards; the best case scenario, some useful form of mutual recognition system.

The only specific information we have so far is that which is contained within the "Great Repeal Bill". The UK government has put great emphasis on the bill. However, it is a bill which is to convert EU law into UK law: so it is not really a repeal bill. Nor is it of itself great – it is a relatively short bill, now explained in the government's white paper.

The bill seeks to do the following:

- To repeal the European Communities Act 1972 and return power to UK institutions.
- To convert EU law as it stands at the moment of exit into UK law before the UK leaves the EU.
- And to create powers to make secondary legislation to enable corrections to be made to the laws that would otherwise no longer operate appropriately once the UK has left the EU, and also enable domestic law, once the UK has left the EU, to reflect the content of any withdrawal agreement under Article 50.[5]

Europe Today

In terms of further legislation, we also know:

- The government estimates that corrections to the law will require between 800 and 1,000 statutory instruments. This is in addition to those that will be necessary for purposes other than leaving the EU.
- Much political debate has focused on whether this use of secondary legislation is appropriate. There is meant to be a degree of discretion to be exercised and the House of Lords Select Committee on the Constitution has raised the challenges to mark the difference between "the more mechanical act converting EU law into UK law, and the discretionary process of amending EU law to implement new policies in areas that previously lay within EU's competence".
- And the government's response to this challenge is simply to say that, without powers for secondary legislation to deal with this issue, it would "require a prohibitively large amount of primary legislation to correct these problems", which, of course, is not really an answer to the question. Certainly though, Secretary of State for Exiting the European Union David Davis states clearly in the foreword to the white paper that the Great Repeal Bill "is not a vehicle for policy changes – but it will give the government the necessary power to correct or remove laws that would otherwise not function properly once we have left the EU."

The Great Repeal Bill makes no mention of financial services or any other particular sector, so we will need to await the further bills and other secondary legislation to see quite what detail is to be proposed for transposing laws as at the exit date.

The post-Brexit deal will be set out in further bills in due course. For any post-withdrawal deal, there will be a separate process from the Great Repeal Bill process. Any final agreement is to be voted on by both Houses of Parliament before it is concluded. Any new treaty to be agreed with the EU would also be subject to the provisions of the Constitutional Reform and Governance Act 2010 before ratification.[7]

Although we cannot predict the outcome of negotiations, the relevant issues for asset managers to debate, and on which to lobby, include the following:

Equivalence or mutual negotiation?

The ideal outcome of any deal might be a mutual recognition system, but we would need to invent an appropriate format for that.

Certainly there are no existing powers that will help. Despite all the talk of third-country equivalence regimes, these simply do not exist:

- There is prospectively one available under the AIFMD, but it is not yet switched on. Despite ESMA's Opinion of September 2016, there are continuing uncertainties as to whether the AIFMD third-country regime will be switched on and if so, whether or not it would actually help.[8] Most countries currently operating under the National Private Placement Regime (NPPR) will likely prefer to continue using it.

> **The Great Repeal Bill will not aim to make major changes to policies or establish new legal frameworks in the UK beyond those which are necessary to ensuring the law continues to function properly from day 1. Therefore the government will also introduce a number of further bills during the course of the next two years to ensure we are prepared for our withdrawal — and that Parliament has the fullest possible opportunity to scrutinise this legislation.[6]**

- There is the prospect of third-country passporting regimes coming in under MiFID II and MiFIR with effect from January 2018: and there are two variants to review. But, even if these are made available - and, of course, as at the date of exit, the UK will be fully equivalent and so an equivalence decision would be likely to be forthcoming – these would likely be an inadequate substitute for a full MiFID passport.

UK firms will likely be reluctant to agree to utilise any such third-country regime on the existing understanding of equivalence and the process for achieving it and maintaining it. There are three main obstacles here.

- Firstly, the bottom line is that, unless and until equivalence is agreed to be a broader concept, the notion of using these equivalence regimes does not work well. Currently there is a notion of equivalence by way of a line by line equivalence comparison analysis. Instead of this, the analysis should probably recognise the equivalence of outcomes (rather than the equivalence of input). Indeed, developing the notion of equivalence should perhaps be viewed as a necessary part of a wider debate – strengthening the regulation of the financial sector on a global basis.[9] The likelihood is that firms will be reluctant to agree to utilise any third-country regime on the basis of full equivalence.
- Secondly, there is a moving target because the regulation with which one is trying to be equivalent will change over time. Post-Brexit, subject to the terms of any post-Brexit deal, the UK would have no control over how it might change. This might be fixed by facilitating the involvement of the UK in, or at least the attendance of UK representatives at, ESMA's and other European regulatory meetings and generally by ensuring full cooperation between regulators, but this would need to be a specific part of the Brexit deal.
- Thirdly, even if equivalence were obtained and one took a view on one's ability to maintain equivalence, the equivalence decision could be switched off at any time. And so it would be unlikely to be viewed as a reliable business model. Again this might be fixed by specific assurances contained within a specific post-Brexit deal.

For any equivalence, or preferably bespoke mutual recognition, system to work, there would need to be specific negotiation of the terms for it, and a specific bespoke deal that moved on quite markedly from the potential third-country equivalence regimes that are currently documented and so within the EU's sights.

Absent positive news of any innovative mutual recognition regime being on the table or agreed, the current focus is on formulating fall-back plans focusing on other areas, as explained below.

Delegation

The first, and key, question is: how much can still be carried on in London?

For most, the focus is on how to achieve effective continued delegation of investment management and other functions from EU firms and EU-based fund vehicles to the UK-based investment management firm, assuming that the UK will, post-Brexit, be a third country.

It is probably fair to assume that the position for the UK should not be less helpful than the position that third countries, such as the US, currently enjoy. However, it is necessary to work through the details of the precise delegation powers to third countries and also the way in which EU regulation will be applied in the countries from which the delegations are to be made.

There are differing conditions for delegation to a third country in respect of delegation of portfolio management:

- ✓ For UCITS.
- ✓ For an AIF under the AIFMD.
- ✓ And by a MiFID firm providing MiFID investment services.

Each of these nuances needs to be noted and considered carefully. For each product or service, one needs to look at the relevant source provisions.

As part of this exercise, one needs to look at current interpretations of each of these provisions, how such interpretations may develop over time and how they may differ between EU Member States, most notably Luxembourg and Dublin.

The interpretations may also develop over the course of the Brexit negotiations.

ESMA's Work Programme for 2017 includes pursuing common approaches on delegation of collective portfolio management and depositary functions under UCITS and the AIFMD, including promoting a common understanding of the "substance" requirements for UCITS management companies and AIFMs.[10]

Various ESMA opinions are expected in July on various topics including delegation and these are awaited with interest. They could herald a strengthening of currently imposed standards. Certainly Steven Maijoor's speech on 11 April 2017 is clear in discussing his view that ESMA should coordinate consideration of key issues and that there is a case for stronger supervisory convergence powers.[11] UK asset managers will need to monitor this ESMA workstream because it might well affect prospective arrangements for delegation arrangements for investment management and other services back to the UK from EU-based firms and products.

Management Companies (ManCos)

Of course, the corollary of the question about how much can still be carried on in London is: how much should be carried on in the location from which the delegation is made?

Typically for asset managers, this equates to how much needs to be carried on in the domicile where investment funds are established, so Luxembourg's and Dublin's regulatory requirements for the resourcing of UCITS ManCos and the AIFMs are crucial.

Most UK-based asset managers have operations in at least two of the three main fund domiciles (the UK, Luxembourg and Dublin) and so can look to build up their UCITS and AIF ManCo arrangements from an existing starting point. UK-based asset managers may decide to utilise Article 6(3)/(4) UCITS provisions, or Article 6(4) of AIFMD powers, so that it is possible for portfolio management to be encompassed within their ManCo operations.

Clearly, in all fund domicile jurisdictions, there has been considerable focus in recent years on fund governance. When we were looking at UCITS IV, there was much discussion of ManCo "letterbox" issues, and perhaps some of these still remain, but certainly many are looking to strengthen the resources of their ManCos.

Current discussion regarding Brexit plans often focuses on how much real strength needs to be created in ManCo establishments: is considerable investment required in Luxembourg or Dublin in manpower and other resources?

Notably the Central Bank of Ireland in December 2016 concluded its consultation process on fund management company effectiveness.[12] This comprises a package of measures, including certain rules with which all ManCos need to comply and additional guidance, which is designed to ensure compliance by ManCos with their regulatory obligations and to allow the Central Bank to carry out its engagement model without undue constraint.[13]

There are location rules to follow — which depend on the ManCo's PRISM rating.[14] If low, the ManCo must have at least two Irish resident directors, half of its directors resident in the EEA and at least half of the managerial functions carried out by at least two designated persons resident in the EEA. For firms with a rating of medium-low or above, they need three Irish resident directors or two Irish residents and one designated person who is Irish resident, half of the directors located in the EEA and at least half of the management functions carried out by at least two designated persons located in the EEA.

Based on CP86 feedback statement, the factors that the Central Bank of Ireland considers relevant to the location of key personnel when considering the extent to which the Central Bank is in a position to exert effective supervisory influence over a firm and its management where those personnel are in a location rather than Ireland include: physical proximity, demographic, cultural and historic ties, ease of travel, homogenous legal and regulatory environment, commonalities of the legal system, and similarities of approach to regulation, supervision and enforcement. These factors would all suggest that a hard Brexit scenario — one, for example, in which the UK is no longer part of the EEA — would not prevent Irish ManCos with UK-based designated persons and/or directors from continuing to satisfy these requirements.

Obviously, though, ESMA's work and any requirements that come from it would need to be considered both in Dublin and in Luxembourg, which might change the position.

Host ManCos

Given the space, personnel and other practical circumstances, particularly for Luxembourg, the use of hosted arrangements with third-party ManCos is increasingly likely to be a topic for discussion. Where this is the case, this introduces its own new challenges.

These are well known in respect of AIF and offshore models, and more recently these have been more popular for new startups, even in the UK, because of the cost of entry for a new ManCo: this has led various investment managers to use hosted arrangements.

While host ManCos, and SuperManCos encompassing other investment services for EU clients, have their theoretical attractions, prudence would suggest that investment managers work through all the practical implications of hosted solutions.

There are drawbacks for the investment managers, principally loss of control and influence at the core of the product structures. A hosted solution might be viewed as isolating the product provision and its risk management from the day-to-day investment management. The investment manager may legitimately take the view that it is only interested in the latter, the day-to-day investment management. But using the hosted solution does change the whole product provision dynamics from those models that have traditionally been used — with asset managers having their own ManCos. So investment managers should appreciate the full ramifications of using the hosted model before going down that route.

Future provision of MiFID investment services to EU clients

Whether using one's own ManCo or a host ManCo arrangement, a common question UK asset managers are asking is whether the ManCo can offer a suitable EU base for provision of ancillary investment services to EU-based clients. This could solve a problem that many UK asset managers face, if and when the UK MiFID firm passports are switched off.

Positive action will likely be required with regard to MiFID investment services provided under segregated mandates directly to EU-based clients. Generally, to the extent necessary, they have been using their UK-based investment management firms with a MiFID passport to date.

Unfortunate variances exist in the current interpretation of MiFID I application — with regard to whether or not services are provided

in another EU Member State if provided by investment managers located in London. While the answer ought to remain focused on where the services are performed, some Member States are taking the view that one should focus on is where the recipient of the service is located. In the absence of certainty of interpretation, managers are likely to ensure that there is a MiFID firm that can ease its way to passporting MiFID services around Europe in the future.

There are therefore two options to consider:

- Whether additional services can be offered by a UCITS ManCo under Articles 6(3)/(4) provisions or by an AIFM under the terms of Article 6(4) of the AIFMD – hence the interest in developing the notion of "SuperManCos — but this approach does likely have its limitations.
- And whether most managers wishing to do a full service will likely set up their own individual MiFID firms in another EU Member State, the choice of State being dependent on the manager's historic connections and other individual preferences.

The differences between the debates on UCITS ManCo and AIFM substance requirements and a MiFID firm's substance should be considered carefully.

To take the Irish scenario, a MiFID firm must satisfy the Central Bank that its head office is in Ireland. There is no definition of what constitutes a head office. The Central Bank is of the view that it means the location of the mind and management of the firm and the place where the day-to-day decisions about the direction of the MiFID firm's business are taken. In effect, this means that a certain number of directors and senior managers must be located in Ireland. The Central Bank would usually expect to see certain key functions located within the head office, such as financial control, legal and compliance, and risk management. The Central Bank acknowledges that a MiFID firm may be integrated into its overall corporate group structure as this can be a source of significant strength and resilience. Accordingly the Central Bank's precise requirements will be informed by the size and complexity of the MiFID firm's business.

Crown dependencies

UK asset managers have traditionally set up funds in the UK plus either or both of Luxembourg and Dublin, and also various offshore centres. Of those offshore centres, Jersey, Guernsey and the Isle of Man (Crown dependencies) have been used by some as offshore fund domiciles.

The government has indicated it is committed to engaging with them as it works towards leaving the EU, but as yet we have no specifics on how.

Aside from such issues, a key challenge that is emerging concerns the timeline for agreeing the post-Brexit deal and how it might be implemented.

A key part of an orderly exit will be a suitable timeframe. However the negotiations progress, the two-year process is unlikely to be sufficient. Some transitional arrangements may in reality be needed, however well the negotiations go. As commented in the recent House of Commons Select Committee Report regarding any "phased approach":

> There is no precedent for the conclusion of a major comprehensive bilateral or multilateral FTA covering goods and services within two

years, although there is also no precedent for the negotiation of a major FTA between countries that are already convergent in legal and regulatory terms. It may be that starting from this position of convergence enables the terms of a future trade deal to be negotiated more quickly than comparable agreements such as CETA. It is not yet evident, however, that the two-year timetable for achieving this is realistic.[15]

What the new Free Trade Agreement (FTA) might look like is, of course, a matter of conjecture. On the potential wish list, there might be the following:

- An open door to skills so that there can be a good system for cross-border movement of skilled persons, including those with financial services skills.
- Some new mutual recognition system for the UK, for UCITS at least, so that:

  Existing UK UCITS that passport into the EU can continue to do so.

  And EU-based UCITS can have a new version of Section 264 FSMA so they can passport into the UK. (One suspects there is little appetite for replacing much of the fund range currently promoted into the UK, notably, for example, Irish-based ETF products.)

- A sound understanding on how delegation arrangements can work effectively to UK-based portfolio management teams in respect of all three strands of a UCITS delegating portfolio management, an AIFM delegating portfolio management and a MiFID firm's delegation of investment management.
- And, on the understanding that there is such a high level of interconnectedness between the UK and Europe regarding financial markets, some cooperation between regulators continuing, particularly in communications relating to ESMA workloads.

Pending certainty emerging from the Brexit negotiations, and clarity on the timetable, UK asset managers now need to plan – possibly on a number of alternative bases. Not surprisingly, UK asset managers are having to assume the "worst-case-scenario" basis, at least as one of their working models, so that they are prepared for anything. Perhaps we should regard any potentially creative and constructive outcome of the post-Brexit deal as a bonus?

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With grateful thanks to Brian McDermott of A&L Goodbody for the views concerning the Irish regulatory position in this article.

1 The chart is extracted from the European Commission's white paper: The Future of Europe: Reflections and Scenarios for the EU27 by 2025, issued on 1 March 2017.

2 See https://www.gov.uk/government/publications/the-great-repeal-bill-white-paper, last downloaded on 11 May 2017. Link here.

3 See https://ec.europa.eu/commission/white-paper-future-europe-reflections-and-scenarios-eu27_en, last downloaded on 11 May 2017. Link here.

4 See http://www.consilium.europa.eu/en/meetings/european-council/2017/04/29/, last downloaded on 11 May 2017. Link here.

5 See http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/577971/EPRS_BRI(2016)577971_EN.pdf:, last downloaded on 11 May 2017. Link here.

6 Paragraph 1.21 HM Government White Paper: The United Kingdom's exit from, new partnership with, the European Union CM 9417.

7 For a summary of the Act, see http://services.parliament.uk/bills/2009-10/constitutionalreformandgovernance.html, last downloaded on 11 May 2017. Link here.

8 See https://www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries, last downloaded on 11 May 2017. Link here.

9 For further development of this idea see speech "The High Road to a Responsible, Open Financial System" by Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, delivered on 7 April 2017, accessible via http://www.bankofengland.co.uk/publications/Pages/speeches/2017/973.aspx, last downloaded on 11 May 2017. Link here.

10 See https://www.esma.europa.eu/document/esma-2017-work-programme, last downloaded on 11 May 2017. Link here.

11 Steven Maijoor, Chair ESMA, closing keynote speech, CMU Mid Term Review Public Hearing, European Commission Brussels, 11 April 2017.

12 See https://www.centralbank.ie/docs/default-source/publications/Consultation-Papers/cp86/161219_cp86-feedback-statement_third-consult_final_rhd.pdf?sfvrsn=4, last downloaded on 11 May 2017. Link here.

13 For a more detailed summary of the CP86 package, please see the separate article from A&L Goodbody, included in this publication.

14 The Probability Risk and Impact SysteM™ (PRISM™) is the Irish Central Bank's risk-based framework for the supervision of regulated firms.

15 Paragraph 45 House of Commons Select Committee Report published 29 March 2017, and for further information see paragraph 283 of that Report.

ROBO-ADVISERS IN THE US: THE EMERGING REGULATORY FRAMEWORK

The last few years have seen significant growth in the availability and popularity of automated digital investment advisory programmes (often called "robo-advisers"). These programmes allow individual investors to create investment accounts through a web portal or mobile application, sometimes with little or no interaction with a human being, with the potential benefit of lower costs than traditional investment advisory services.

Given the emergence of the robo-adviser industry, the U.S. Securities and Exchange Commission (SEC), the primary regulator of robo-advisers doing business in the US has taken a keen interest in ensuring that robo-advisers under its jurisdiction meet their regulatory and compliance obligations under the Investment Advisers Act of 1940, as amended (the Advisers Act).[1]

In this article, we provide an overview of the robo-advisory industry and typical business models. We then discuss the particular regulatory and compliance risks that SEC staff has identified in the typical robo-adviser business model and staff suggestions for addressing these risks.

The robo-adviser business model

Robo-advisers incorporate technologies into their portfolio management platforms primarily through the use of algorithms designed to optimise wealth management services. Robo-advisers' business models range from fully automated platforms (which have features that let investors direct the management of their portfolios without direct human interaction) to "hybrid" or adviser-assisted platforms (which combine a digital client portal and investment automation with a virtual financial adviser typically conducting simple financial planning and periodic reviews over the phone).

Robo-advisers typically collect information on clients and their financial history using online questionnaires. These questionnaires often solicit information on the client's age, income, investment horizon, risk tolerance, investment experience and investment objectives, among other information. Robo-adviser platforms use the information input by the client to help the client select a risk profile. The firms then use algorithms to generate a suggested investment strategy for the client based on that risk profile. Platforms can automatically rebalance clients' portfolios in response to the performance of the portfolio's investments and the clients' goals.

The SEC's regulatory and compliance expectations for robo-advisers

The SEC regulates investment advisers, which generally includes firms that provide digital wealth management platforms. Robo-advisers registered with the SEC are subject to the same regulatory framework as traditional investment advisers that are registered with the SEC.

The SEC has made it clear that it plans to dedicate significant regulatory scrutiny to robo-advisers going forward. For example, in its Examination Priorities Letter for 2017, the SEC's Office of Compliance Inspections and Examinations (OCIE) listed "Electronic Investment Advice" as its first examination priority under the topic of "Protecting Retail Investors."[2] In addition, the SEC has released an Investor Bulletin to help explain the costs, risks and benefits of robo-advisers to retail investors[3] and an Investor Alert that provides investors with a general overview of robo-advisers and other automated investment tools.[4]

The staff of the SEC's Division of Investment Management (IM Staff) recently issued a Guidance Update to assist SEC-registered robo-advisers in meeting their regulatory and compliance obligations under the Advisers Act.[5] Through the Guidance Update, the IM Staff seeks to inform robo-advisers and other investment advisers using algorithms to provide investment advice of certain unique considerations they should take into account in meeting their legal obligations under the Advisers Act.[6] In addition, the Guidance Update offers suggestions for how these advisers may address some of these issues.

As an initial matter, the IM Staff notes in the Guidance Update that robo-advisers have certain "unique considerations" in seeking to satisfy their legal obligations under the Advisers Act. In particular, the IM Staff explains that certain hallmarks of the typical robo-adviser business model – such as reliance on algorithms, delivery of advisory services over the internet and limited, if any, direct human interaction – create novel regulatory and compliance issues that generally do not arise in connection with more common advisory business models. It is with these unique considerations in mind that the IM Staff provides guidance to robo-advisers.

In the Guidance Update, the IM Staff addresses three discrete regulatory and compliance issues:

- First, the substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers.
- Second, the information obtained from clients to support the robo-adviser's duty to provide suitable investment advice.
- And third, the adoption and implementation of an effective compliance programme reasonably designed to address the particular concerns relevant to providing automated investment advice.

Below, we provide an overview of the regulatory and compliance challenges identified by the IM Staff with respect to these three discrete areas together with their suggestions as to how robo-advisers can address these challenges. Finally, although the topic was only briefly addressed in the Guidance Update, we provide an overview of the regulatory and compliance considerations for robo-advisers under Rule 3a-4 under the Investment Company Act of 1940, as amended (Rule 3a-4).[7]

Substance and presentation of disclosures

The fiduciary duty that binds all investment advisers, including robo-advisers, creates a duty to make full and fair disclosure of all material facts to, and employ reasonable care to avoid misleading, clients.[8] This disclosure must include substantive information that gives the client an opportunity to make an informed decision about whether to enter into, or continue, an investment advisory relationship with the robo-adviser. The key aspects of the disclosure must also be readily apparent to the client.

With respect to the substance and presentation of disclosure, the IM Staff stated that the typical robo-adviser business model creates a number of unique regulatory and compliance challenges, including:

- Limited or non-existent interaction with the advisory personnel, which means a client's ability to make an informed decision regarding entering into an advisory relationship may be solely dependent on electronic disclosures, i.e. advisory personnel may not be available to explain or reinforce important disclosures.
- And the risk that the client may misunderstand the robo-adviser's business model or its scope of services, or that information may be buried or incomprehensible for the client.

To address these regulatory and compliance challenges, the IM Staff provides several suggestions for the content of a robo-adviser's disclosure, and how it can be presented to increase client awareness. Some examples of these suggestions include the following.

- With respect to disclosures regarding the robo-adviser's business model, there should be a description of:

  The assumptions and limitations of the algorithm used to manage client accounts, e.g. if the algorithm is based on modern portfolio theory, a description of the assumptions behind the theory and the limitations of that theory.

  The particular risks inherent in the use of an algorithm to manage client accounts, e.g. that the algorithm might rebalance client accounts without regard to market conditions or on a more frequent basis than the client might expect and that the algorithm may not address prolonged changes in market conditions.

And any circumstances that might cause the robo-adviser to override the algorithm used to manage client accounts, e.g. that the robo-adviser might halt trading or take other temporary defensive measures in stressed market conditions.

- With respect to disclosure regarding the robo-adviser's scope of services, there should be a statement that the robo-adviser does not provide a comprehensive financial plan, e.g. the robo-adviser does not take into consideration a client's tax situation or debt obligations, or the advice is only targeted to meet a specific goal, such as paying for a large purchase or college tuition, without regard to the client's broader financial situation.
- And with respect to the presentation of disclosures, robo-advisers should emphasize key disclosures, e.g. through design features on the robo-adviser's website such as pop-up boxes.

Provision of suitable investment advice

Like all investment advisers, robo-advisers have a fiduciary duty to act in the best interests of clients and to provide only suitable investment advice. According to the IM Staff, the typical robo-adviser business model creates a number of challenges with respect to the robo-adviser's obligation to provide suitable investment advice, including:

The client questionnaire a robo-adviser may use to elicit critical information needed to understand the client's financial situation, goals and investment objective might not provide a client with an opportunity to give additional information or context for the client's responses.

A robo-adviser may not be designed so that advisory personnel may ask follow-up or clarifying questions about a client's responses, address inconsistencies in the responses or provide a client with help when filling out the questionnaire.

And a client may have the option of selecting a portfolio other than what is recommended by the algorithm, but may not have the opportunity to consult with investment advisory personnel about the suitability of that portfolio.

To address these regulatory and compliance challenges, the IM Staff provides several suggestions for improving client information-collection practices and providing suitable investment advice. Examples of these suggestions include:

- Implement systems to automatically flag inconsistent information provided by a client for review or follow-up by the robo-adviser, e.g. alert clients through pop-up boxes or other design features when there are inconsistencies between the client's stated investment objective and the selected portfolio.
- And provide commentary on why the robo-adviser believes particular portfolios may be more appropriate given the client's stated investment objective or risk profile.

Effective compliance programmes

Rule 206(4)-7 under the Advisers Act requires each registered investment adviser, including registered robo-advisers, to establish an internal compliance programme that addresses the adviser's performance of its fiduciary and substantive obligations under the Advisers Act. According to the IM Staff, the typical robo-adviser's reliance on algorithms, limited human interaction with clients and provision of advisory services over the internet may create or accentuate risk exposures for the robo-adviser that should be addressed through written policies and procedures specially designed to address these risks.

Accordingly, the IM Staff provides suggestions regarding the adoption and implementation of particular written policies and procedures that address certain regulatory and compliance risks that are created or enhanced by a robo-adviser business model, such as policies and procedures governing:

- The development, testing and back-testing of the algorithmic code and the post-implementation monitoring of its performance, e.g. to ensure that the code is adequately tested before, and periodically after, it is integrated into the robo-adviser's platform, the code performs as represented and any modifications to the code do not adversely affect client accounts.
- The questionnaire eliciting sufficient information to ensure it allows the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for the client based on his or her financial situation and investment objectives.
- The disclosure to clients of changes to the algorithmic code that may materially affect their portfolios.
- The appropriate oversight of any third party that develops, owns or manages the algorithmic code or software modules utilised by the robo-adviser.
- And the prevention and detection of, and response to, cyber-security threats.

Compliance with Rule 3a-4

In the Guidance Update, the IM Staff cautions that robo-advisers should consider whether the organisation and operation of their programmes raise any issues under the other federal securities laws, including Rule 3a-4 in particular. In general,

> **"Like all investment advisers, robo-advisers have a fiduciary duty to act in the best interests of clients and to provide suitable investment advice.**

Rule 3a-4 creates a non-exclusive safe harbour from the definition of "investment company" set forth at Section 3(a)(1) of the Investment Company Act of 1940, as amended (the Company Act) for investment advisory programmes that meet the specified requirements under the rule. Among such requirements are that:

- The advisory programme must permit the advisory client to impose reasonable restrictions on the management of his or her account.
- And advisory personnel must reach out to the client annually to determine whether there have been any changes to the client's financial situation or investment objectives, and whether the client wishes to impose any reasonable restrictions on the management of the account or reasonably modify existing restrictions.

In addition, the sponsor of the advisory programme and personnel of the manager of the client's account who are knowledgeable about the account and its management must be reasonably available to the client for consultation.

Given the lack of human interaction associated with many robo-adviser business models, the reasonable availability requirement of Rule 3a-4 may prove challenging for robo-advisers. In addition, to the extent that a robo-adviser's algorithm does not permit clients to place reasonable restrictions on their portfolios, the robo-adviser may not qualify for the Rule 3a-4 safe harbour and may thus be subject to additional risk of being deemed to be an "investment company" under the Company Act.

Conclusion

Given the SEC's staff's focus on the unique regulatory compliance risks created by the robo-adviser business model, all investment advisers doing business in the US and using algorithms to provide digital investment advice to clients should review and, as appropriate, implement the IM Staff's recommendations in the Guidance Update. The SEC staff will likely view the recommendations in the Guidance Update as the minimum regulatory and compliance enhancements that robo-advisers should implement to account for the unique nature of their business model.

In addition, any investment adviser utilising algorithms to provide investment advice (including investment advisers that are not robo-advisers) would be well served to design and implement policies, procedures and internal controls to meet the expectations of the staff as expressed in the Guidance Update.

It is also recommend that such investment advisers consult the Office of the Comptroller of the Currency's (OCC's) Supervisory Guidance on Model Risk Management.[9] Although the OCC does not have jurisdictional authority over investment advisers that are not banks, many advisers have leveraged the OCC's guidance in developing their controls with respect to their use of algorithms in formulating investment advice.

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[1] Robo-advisers with less than USD100 million in regulatory assets under management are generally required to register in any states where they have a place of business and have more than five advisory clients.

[2] See SEC Office of Compliance Inspections and Examinations, National Exam Program, Examination Priorities for 2017 (Jan. 12, 2017), available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf, last downloaded on 5 May 2017. Link here.

[3] See SEC Office of Investor Education and Advocacy, Investor Bulletin: Robo-Advisers (Feb. 23, 2017), available at https://www.sec.gov/oiea/investor-alerts-bulletins/ib_robo-advisers.html, last accessed on 5 May 2017. Link here.

[4] See SEC Office of Investor Education and Advocacy and the Financial Industry Regulatory Authority, Inc., Investor Alert: Automated Investment Tools (May 8, 2015), available at https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html, last accessed on 5 May 2017. Link here.

[5] See SEC Division of Investment Management Guidance Update No. 2017-02, "Robo-Advisers" (Feb. 2017). While the State of Massachusetts' Securities Division issued a policy statement on robo-advisers in April 2016, we expect other States to look to the SEC staff's guidance going forward in deciding how to regulate robo-advisers operating in their jurisdictions.

[6] Although the Guidance Update is mostly directed toward robo-advisers, certain aspects of it also apply to traditional investment advisers that use algorithms to develop investment advice. Accordingly, any investment adviser, whether automated or not, that uses algorithms as part of its business should be familiar with the IM Staff recommendations in the Guidance Update.

[7] See https://www.sec.gov/about/laws/ica40.pdf, last downloaded on 5 May 2017.

[8] See SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).

[9] See Board of Governors of the Federal Reserve System and Office of the Comptroller of the Currency, Supervisory Guidance on Model Risk Management (Apr. 4, 2011), available at: https://www.federalreserve.gov/supervisionreg/srletters/sr1107a1.pdf, last downloaded on 5 May 2017. Link here.

CP86 REGULATORY CHANGES: THE IMPACT FOR FUND MANAGEMENT COMPANIES AND TIMELINES FOR COMPLIANCE

The Central Bank of Ireland (CBI) issued its final rules, guidance and transitional arrangements following three industry consultations on fund management company effectiveness (CP86) since its first consultation issued in September 2014.[1] Below we consider the implications of the final rules and guidance for fund management companies and their promoters and asset managers and what may need addressing before July 2018. While the CBI has noted that divergence from its guidance will not be a regulatory breach, the CBI's supervisors will have reference to its guidance when forming a view as to whether a fund management company has complied with its regulatory obligations.

Background

CP86 set out a number of proposed initiatives designed to enhance the governance and oversight framework for the following entities (each referred to as a Fund ManCo and collectively Fund ManCos):

- UCITS management companies
- Self-managed UCITS investment companies/ICAVs[2]
- Authorised AIFMs
- And internally managed AIF investment companies/ICAVs

As a result of CP86, new rules and guidance were issued by the CBI in relation to the managerial functions of Fund ManCos, the location of directors and designated persons (DPs), who may be a DP, and the introduction of a new organisational effectiveness role for Fund ManCos. In addition, requirements and guidance were issued on record retention and retrievability, directors' time commitments and delegate oversight. We outline what these rules and guidance mean for Fund ManCos and the compliance timelines and requirements below.

Managerial functions, organisational effectiveness role and location of directors and DPs

Prior to CP86, the CBI required Fund ManCos that delegated activities to identify in their business plan (BP) or programme of activity (PoA) a designated director or other DP located in Ireland who would have responsibility for each of the prescribed managerial functions for Fund ManCos.

Under the new requirements, a Fund ManCo that delegates activities will continue to be required to identify a designated director or other DP in its BP/PoA who will have responsibility for each managerial function. However, the managerial functions for all Fund ManCos are consolidated into the following six managerial functions:

1. Investment management
2. Fund risk management
3. Operational risk management
4. Regulatory compliance
5. Distribution
6. And capital and financial management

While the same person may perform more than one managerial function, including both of the risk management functions, the same person will not be permitted to perform both managerial functions relating to risk management and investment management.

In addition, each Fund ManCo will be required to designate an independent director (who could be the chairperson of the board) to undertake an organisational effectiveness role and who should not perform any of the six managerial functions.

The purpose of the organisational effectiveness role is to keep the effectiveness of the organisational arrangements of the Fund ManCo under review, and it will also include monitoring conflicts of interest and internal audit unless monitoring of internal audit is allocated to a DP. The types of matters covered under this role include (but are not limited to):

- Reviewing the organisational structure and arrangements of the Fund ManCo, including those concerning managerial functions, and suggesting improvements for consideration by the board.
- Keeping board composition under review and reporting to the board.
- Organising periodic board effectiveness evaluations and overseeing how well the decisions taken by the Fund ManCo and the arrangements for the supervision of delegates are working in the interests of investors.
- And considering the conflicts of interest affecting the Fund ManCo and its funds under management and initiating action, such as escalation to the board, where these are having, or are likely in the near future to have, an adverse impact.

These changes will require Fund ManCos who are not in compliance to decide how to allocate responsibility for the revised managerial functions and the organisational effectiveness role and to update their BP/PoA within the transitional timeline detailed below. It will also be necessary to consider the adequacy of the policies and procedures that the Fund ManCos have in place to support the BP/PoA in light of the new requirements and guidance.

Managerial functions guidance

Who can be a DP?

Prior to CP86, a DP for a Fund ManCo had to be located in Ireland. The new guidance allows a DP to be a director or employee of the Fund ManCo, or to be seconded to the Fund ManCo, on a full- or part-time basis, from another firm, such as the asset manager or a firm that specialises in the provision of DPs, but it does not require the DP to be located in Ireland. This is an important change as it will allow Fund ManCos to appoint DPs who are based outside Ireland and who may be employees of their promoter/asset manager with relevant expertise, provided that the Fund ManCo complies with the location requirements outlined below.

What is the role of a DP?

While a director can also be a DP, the guidance distinguishes between the role of a director being part of the governing body that is not involved in managing the Fund ManCo on a day-to-day basis and that of a DP that is described as the Fund ManCo's line of management between the board of directors and its delegates.

In brief, the guidance provides that DPs should:

- Monitor and oversee compliance by a Fund ManCo with its obligations and ensure that the strategies, policies and directions issued by the board are acted upon and complied with.
- Report to the board on a regular basis and escalate issues where predefined parameters agreed with the board are exceeded or where the DP judges that immediate escalation is warranted.
- Monitor and oversee Fund ManCo employees or delegates who carry out the tasks that fall within the scope of their responsibility, and review their work on an ongoing basis in a manner agreed with the Fund ManCo.
- Have experience and expertise in the managerial function and enough knowledge of the area to constructively challenge both information received and the people providing it.
- Be sufficiently senior in their role regarding delegates and for the purpose of engagement with the CBI.
- And have enough time available to carry out their roles thoroughly and to a high standard.

The CBI has acknowledged in its guidance that, while DPs should monitor the tasks for which they are responsible on a day-to-day basis, this does not necessarily mean that monitoring and oversight has to take place daily. The frequency of monitoring and oversight by DPs, including the frequency of receipt of information from delegates, should be determined based on the activities of the Fund ManCo and its funds under management. In addition to regularly scheduled monitoring and oversight, more frequent review should occur on an ad hoc basis where circumstances demand this, for example where breaches are occurring or where market volatility has increased.

Where can directors and DPs be located?

Of particular importance are the new requirements about where directors and DPs of a Fund ManCo may be located. These in turn are linked to the CBI's Probability Risk and Impact System (PRISM) rating of a Fund ManCo and which system is designed to ensure that the CBI can adequately supervise Fund ManCos. These requirements will allow for the flexibility to have DPs to be based outside Ireland and provide the following.

A Fund ManCo that has a PRISM impact rating of "low" will be required to have at least:

- Two Irish resident directors.
- Half of its directors resident in the EEA.
- And half of the managerial functions performed by at least two DPs resident in the EEA.

Moreover, a Fund ManCo that has a PRISM impact rating of "medium low or above" will be required to have at least:

- Three Irish resident directors or two Irish directors and one DP based in Ireland.
- Half of its directors in the EEA.
- And half of the managerial functions performed by at least two DPs resident in the EEA.

All Fund ManCos that are self-managed UCITS or internally managed AIFs have a PRISM rating of low.

How can Fund ManCos address these requirements?

All Fund ManCos will already have two Irish resident directors. We expect the additional requirements to be addressed in a number of different ways:

- Board composition: a review of board composition will need to be carried out to ensure that half of the directors are located in the EEA. This may require changes to the board depending on the country of residence of the existing non-Irish resident directors.
- Organisational effectiveness role: most Fund ManCos will already have at least one independent director who will need to be appointed to take on this role.
- Managerial functions: the revised managerial functions will need to be allocated to directors/DPs.

- DPs: Fund ManCos could appoint their own employees, employees of the promoter/asset manager or group employees as DPs, and directors can still act as DPs. Fund ManCos could appoint DPs from a third party provider. Only half the managerial functions must be performed by DPs who are EEA based.
- Brexit: the CBI has indicated that, while it would not be possible to predict the outcome of Brexit negotiations, the CBI would currently consider the UK as having equivalent requirements to an EEA jurisdiction for the purposes of the location requirements. This is helpful for UK promoters and asset managers implementing CP86 solutions that involve UK-based personnel.

Each Fund ManCo will need to include the rationale for its board composition in its BP/ PoA to document how the board as a whole provides it with sufficient expertise to conduct the tasks expected of the directors and, where relevant, the DPs for a managerial function. We understand that it should not be necessary to submit revised BPs/ PoAs to the CBI for review, but any such updates could be subject to spot checks carried out by the CBI.

Additional guidance for Fund ManCos

In addition to the above, as part of CP86 the CBI published guidance for Fund ManCos on the topics outlined below.

Delegate oversight

This guidance focuses on the role of boards, where significant tasks are delegated externally, and sets out a framework for good practice with the monitoring and oversight of delegates, delegated tasks and tasks to be retained. Specific guidelines on the supervision of delegates in relation to investment management, distribution, risk management, and investment operations and administration are included. The guidance also addresses matters to be considered by boards of Irish externally managed investment companies and ICAVs.

In practice, most boards will already follow the requirements of the guidance as a matter of good corporate governance. However, the guidance includes some areas of focus that boards should take into account when reviewing current governance and oversight arrangements.

Directors' time commitments

This guidance recommends that:

- Directors and boards should agree a minimum time allocation for board meeting attendance, which should be documented in each director's letter of appointment, and additional time for ad hoc issues.
- Additional time should be allocated where a director carries out a chairperson's role.
- A DP role for managerial functions should be considered separately to the role of director and a separate time commitment should be allocated.
- A separate letter of appointment should be issued in respect of DP roles for managerial functions, which should be subject to annual review.
- Directors should consider any conflicts of interests and the types and complexity of funds or sub-funds in determining their time commitment.
- And membership of board committees should be considered as a separate role.

This guidance stops short of setting a hard limit on the number of board appointments that a director may hold. However, the CBI currently intends to treat the holding by an individual director of in excess of 20 directorships (of Irish authorised investment funds or Fund ManCos) when combined with an aggregate level of annual professional time commitment in excess of 2,000 hours as a risk indicator, which may entail additional supervisory attention under the CBI's risk-based approach.

If it would be proposed to appoint to a Fund ManCo a director who exceeds the risk indicator thresholds, it could impact the timeframe for the CBI's review of the relevant fund documentation. The recommendations in the guidance may also be used by the CBI for future reviews of board effectiveness, director time commitments and quality of board operations.

Operational issues (record retention and retrievability and email address)

This guidance outlines the CBI's minimum expectations with respect to the retention, maintenance, security, privacy, preservation and accessibility of the documentation, and records pertaining to a Fund ManCo and its funds under management (relevant documents).

In brief, the guidance provides that a Fund ManCo should have immediate and unfettered access from Ireland to all relevant documents, which should be available on request to the CBI. The guidance clarifies that in this context "immediately" means that documents requested by the CBI before 1 pm (Irish time) should be provided to the CBI on the same day, and documents requested after 1 pm should be provided to the CBI before noon on the following day.

Relevant documents would include agreements, reports, documents filed with the CBI, board minutes, policies and procedures, financial statements, minutes of meetings, etc. Relevant documents can be maintained in hard or electronic format.

This guidance also provides that a Fund ManCo must have a record management policy and procedures appropriate to its nature, scale and complexity, and a clearly defined records-retention schedule.

Each Fund ManCo should also maintain a designated and monitored email address for correspondence with, and responding to information requests issued by, the CBI. Guidance is included for the operation and monitoring of the email address, which must be capable of being checked daily. A single address can be maintained for all funds under management or for each fund under management. The CBI may periodically test the effectiveness and efficacy of the designated email address.

Transitional arrangements and next steps

The table overleaf highlights key transitional arrangements, covered by the rules and guidance, concerning Fund ManCos according to when they have been authorised. Fund management companies will want to ensure they address two key points in particular. They will want to be sure they address making changes to their organisational structure and updating their BPs/PoAs accordingly. Of particular importance will be the consideration of the board and DP composition, the allocation of the managerial functions and the organisational effectiveness role to ensure that the requirements can be addressed within the prescribed timelines.

Existing entities can make changes to their organisational structure during the transitional period, but only changes that bring them closer to compliance with the final rules and guidance.

<table>
<tr><th>Rules and guidance</th><th>Fund ManCo Authorised before 1/11/2015</th><th>Fund ManCo Authorised between 1/11/2015 and 30/06 2017 (inclusive)</th><th>Fund ManCo Authorised after 30/06/2017</th></tr>
<tr><td>Six managerial functions</td><td>1/07/18</td><td colspan="2">Applicable from date of authorisation.</td></tr>
<tr><td>Performance of the organisation effectiveness role</td><td>1/07/18</td><td colspan="2">Applicable from date of authorisation.</td></tr>
<tr><td>Location rule</td><td rowspan="2">1/07/18</td><td rowspan="2">1/07/18</td><td rowspan="2">The CBI will only authorise entities organised in a way that complies with these provisions.</td></tr>
<tr><td>Retrievability of records</td></tr>
<tr><td>Guidance: delegate oversight</td><td>4/11/15</td><td colspan="2">Applicable from date of authorisation.</td></tr>
<tr><td>Guidance: organisational effectiveness</td><td colspan="3">Applicable from the date that a Fund ManCo has appointed a person to the organisational effectiveness role or from 1/07/18 at the latest.</td></tr>
<tr><td>Guidance: directors' time commitments</td><td>4/11/15</td><td colspan="2">Applicable from date of authorisation.</td></tr>
<tr><td>Guidance: managerial functions</td><td>1/07/18</td><td>1/07/18</td><td>Applicable from date of authorisation.</td></tr>
<tr><td>Guidance: operational issues</td><td>Retrievability of records: 1/07/18.
Dedicated email address: 30/06/17, but CBI requesting email address to be communicated to it before 28 April 2017.</td><td>Retrievability of records: 1/07/18.
Dedicated email address: 30/06/17, but CBI requesting email address to be communicated to it before 28 April 2017.</td><td>Retrievability of records: applicable from date of authorisation.
Dedicated email address: applicable from date of authorisation.</td></tr>
<tr><td>Guidance: procedural matters</td><td colspan="3">This guidance is a reflection of the existing Fund ManCo guidance, so no transitional arrangements apply.</td></tr>
</table>

Key points to be addressed:

- Fund ManCos will need to consider final rules and guidance and update their BPs/ PoAs within prescribed timelines, particularly as they concern board and DP composition, the allocation of the managerial functions and the organisational effectiveness role.
- Fund ManCos will need to consider the adequacy of their policies and procedures to support their BPs/PoAs and in light of the new requirements and guidance, including as highlighted under operational issues above.

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[1] For the CBI's Feedback Statement on the Consultation, please see https://www.centralbank.ie/docs/default-source/publications/Consultation-Papers/cp86/161219_cp86-feedback-statement_third-consult_final_rhd.pdf?sfvrsn=2, last downloaded on 21 May 2017. Link here.

For the Fund Management Companies – Guidance, please see https://www.centralbank.ie/docs/default-source/Regulation/industry-market-sectors/Funds/UCITS/Guidance/fund-management-company-guidanceb34cc0134644629bacc1ff0000269695.pdf?sfvrsn=2, last downloaded on 21 May 2017. Link here.

[2] Irish Collective Asset-management Vehicles (ICAVs).

RECENT DEVELOPMENTS FOR DIRECTORS IN THE LUXEMBOURG INVESTMENT FUND INDUSTRY IN RELATION TO VALUE ADDED TAX

Recent developments in Value Added Tax (VAT) are worth considering for directors sitting on the board of investment funds and management companies in Luxembourg. Firstly, the Luxembourg VAT law introduced a personal and joint liability of managers since 1 January 2017. Secondly, there's the VAT treatment of directors' fees paid by investment funds and their management companies. Because of these developments, we expect boards and authorities to put more focus on VAT liabilities and obligations of entities in the fund sector.

Introduction of the personal and joint liability of managers in the Luxembourg VAT Law

The Law of 23 December 2016[1] (the Tax Reform) has introduced new provisions[2] in the Luxembourg VAT Law according to which managers of companies can be held jointly and personally liable in the event of a breach of VAT compliance obligations or VAT non-payment by the company or companies they manage. These new provisions have been applicable since 1 January 2017.

Managers and executive directors of Luxembourg companies should be aware of such measures as they can be held liable for the payment of VAT if the companies they manage have not complied with their VAT duties (e.g. no/late submission of the VAT registration application or of VAT returns and no/late payment of VAT).

Although this specific liability is new for VAT, its regime is not completely unknown as a similar liability has existed for decades for direct taxes. The legislative history of the Tax Reform made a clear link between the two types of liability. Hence, it is worth learning from the existing case law to better understand the extent of this new VAT liability.

Case law listings from the administrative courts show that the liability of managers for direct taxes is not theoretical and the direct taxes authority do not hesitate to call managers in guarantee for the payment of direct taxes. Likewise, the Luxembourg VAT authority[3] (VAT Authority) announced in its 2016 progress report[4] (where the objectives for 2017 are stated) that it intends to make use of this new collection tool. Managers should therefore carefully monitor the tax obligations of the companies they manage.

The purpose of this section is to outline the extent of the scope of this liability, as well as its consequences and how managers can protect themselves, either in a corrective or preventive manner.

Scope of the liability

The personal and joint liability for VAT applies to the following persons (hereafter referred as Managers or Manager):

- Managing directors (*administrateurs délégués*)
- Managers (*gérants*)
- And any de jure or de facto managers (*tout dirigeant de droit ou de fait*) in charge of the daily management of VAT-taxable persons[5]

Having a close look at the list of persons to which the new liability applies, it appears that non-executive directors are out of scope. The provision covers the persons in charge of running the company, be it on the basis of the company law, a specific delegation of power or factual elements. The persons in scope are mainly persons who are regularly appointed as Managers, but it could also be entities or individuals who behave as if they were Managers in charge of the daily management of the company (i.e. de facto managers).

The Law does not define the term "de facto manager". According to case law, a de facto manager is the person who has the right to dispose of assets and acts toward third parties like a person authorised to dispose of assets. Based on German case law, a de facto manager could, for example, be a payroll agent having a bank account authorisation.[6] However, because the Luxembourg VAT Law catches de facto managers in charge of the daily management only, we believe that such an agent would not be liable to VAT under Luxembourg law under the assumption that he is not in charge of the daily management.

The limitation to de facto managers in charge of the day-to-day management will avoid giving too broad a scope to the new VAT liability. Luxembourg laws do not provide a definition of what "daily management" is. Based on case law, what is within daily management depends from one company to another and shall be determined on a case-by-case basis, taking into account the corporate object, the sector of activity and the size of the company. As a general rule, daily management encompasses two types of acts: acts required within the frame of the daily life of the company (which are the daily execution of decisions taken by the board) and acts of minor importance (which require a prompt action). So it appears that the daily management involves a power that is general and not specific in nature.

It seems that a management executive officer (*directeur général*), within the meaning of the new article 60-1 of the commercial companies law, could be held liable for VAT, as such an officer is usually in charge of managing the company's day-to-day operations.[7]

Managers may be held jointly and personally liable in the event of a company breach of VAT-compliance obligations or non-payment of the VAT due from the funds they manage.[8] They can only be held liable if they have failed in the performance of their duties (*inéxecution fautive*).

To establish a failure in the performance of duties, three elements are required: a fault (by the Manager), a damage (for the Grand-Duchy of Luxembourg) and a causal link between the fault and the damage. The fault does not necessarily require a wilful misconduct and could be characterised by mere carelessness or negligence.

A fault could notably be recognised when a Manager has not made sure that VAT obligations have been complied with. A fault could be recognised even if the preparation of VAT returns is externalised to a third-party provider, for instance a domiciliation company, accountant or tax adviser.

Consequence: guarantee call notice

In case of failure in the performance of their duties, Managers are personally and jointly liable for the payment of VAT due by the taxable person they manage.

The VAT Authority is entitled to issue a guarantee call notice (*décision d'appel en garantie*) against the defaulting Managers.

This decision to issue a guarantee call notice is at the discretion of the VAT Authority, which should be motivated. It implies that if a company is managed by several Managers, the VAT Authority can issue a guarantee call notice against one manager only and not against the others.

The joint liability implies that the Managers who have received a guarantee call notice cannot invoke a benefit of discussion or a benefit of division. It notably means that the Managers cannot refuse to pay the VAT due by the company or the fund they manage because the latter is solvent or because the VAT Authority has not previously enforced VAT collection from the company. Indeed, the insolvency of the taxpayer or the unsuccessful recovery of the tax by the VAT Authority is not a pre-requisite to launching the new procedure against the Managers of that taxpayer.

In the case where there are several Managers, the Manager who has received a guarantee call notice cannot ask for a split of the tax debt between the different Managers. The VAT Authority is therefore authorised to ask the payment of the whole amount to one of them. In this case, the VAT Authority should be able to explain their choice.

A Manager who receives a guarantee call notice has the possibility to challenge it. A written claim duly motivated should be sent to the director of the VAT Authority within the three months of the notification date mentioned on the guarantee call notice.

The claim does not suspend the enforcement of the guarantee call notice. The Manager shall pay the VAT payable amount that is challenged within one month of the notification date.

If the director of the VAT Authority rejects the claim or if he or she does not answer within the six months following the filing of the claim, the Manager may lodge an appeal in front of the Luxembourg civil court (*Tribunal d'arrondissement de Luxembourg, siégeant en matière civile*) subject to specific formal requirements. This appeal must be introduced within three months following the explicit decision of rejection issued by the director of the VAT Authority.

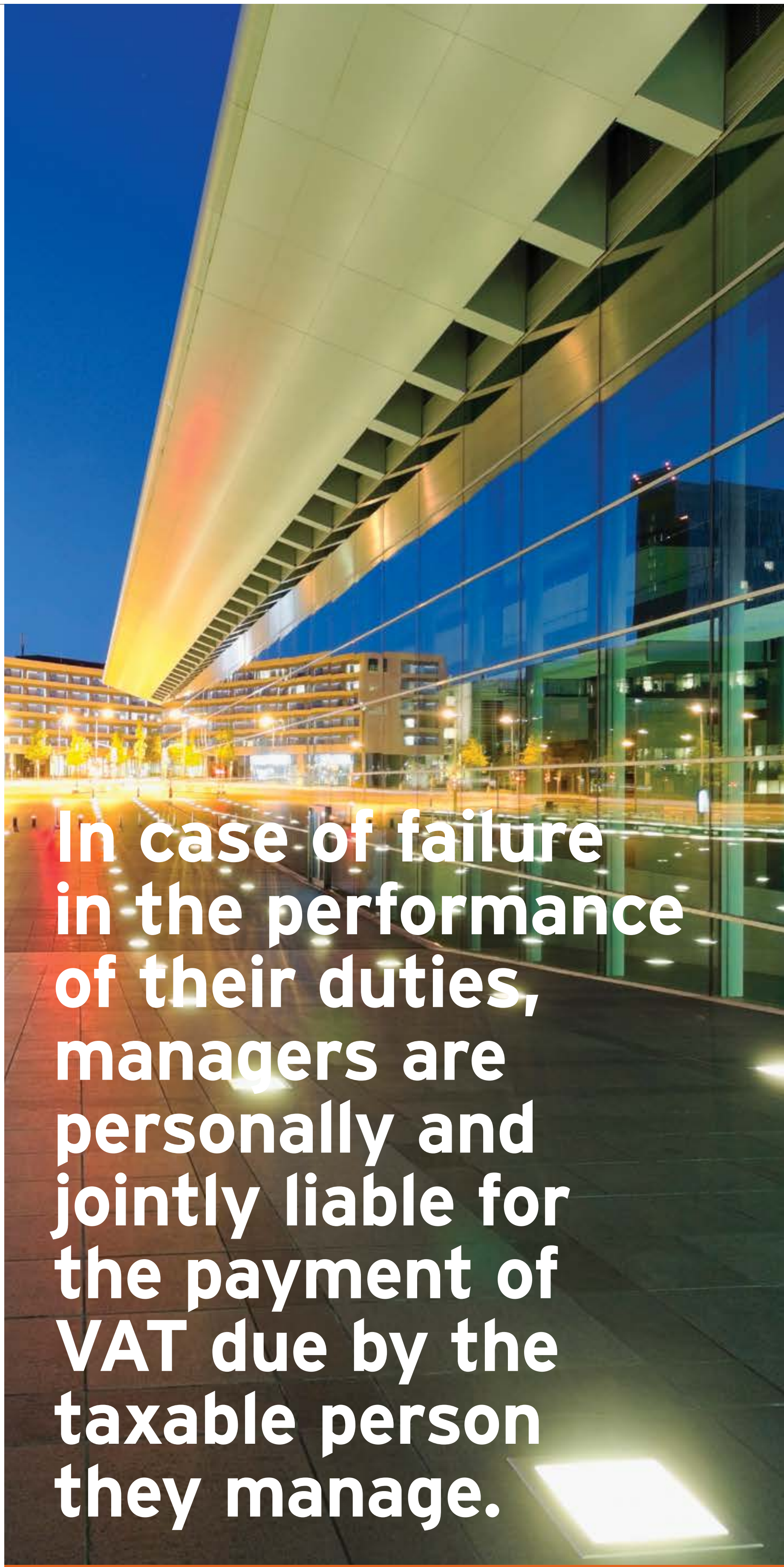
Case law related to guarantee call notices for the payment of direct taxes demonstrates that it is generally difficult for Managers to escape their liability. The tax authority and the courts generally consider that Managers shall have the required competency to deal with the tax obligations of the company. The lack of remuneration, the lack of competency or the lack of involvement do not exempt a Manager from his or her liability. As already highlighted, even in case of delegation of tasks, the Manager remains liable as he or she shall ensure an uninterrupted monitoring of the performance of his or her duties by the service provider.

Points of attention and recommendations

This new liability impacts Managers during their mandates, of course, but it is important that Managers know that it could also have repercussions before and after their appointment. A newly appointed Manager can indeed be held liable for ongoing failures relating to VAT due for past periods, as the obligation to pay VAT survive until effective payment. Similarly, a removed Manager remains liable after the termination date for failures in performance of their duties during the mandate.

This new liability together with the general increase of VAT penalties and creation of criminal penalties underline the importance of being fully compliant at all times with Luxembourg VAT legislation and, in particular, of ensuring that the company always:

- Registers for VAT on time.
- Files accurate and complete VAT returns.
- Files VAT forms and pays the related VAT within the deadlines.
- Complies with other VAT obligations (issuance of valid invoices, accounting, FAIA (Fichier Audit Informatisé AED) when required).
- Computes amounts of recoverable VAT and payable VAT based on accurate figures.



In case of failure in the performance of their duties, managers are personally and jointly liable for the payment of VAT due by the taxable person they manage.

- Promptly provides information and documents, in the event of questions from, or an audit being carried out by, the VAT Authority.
- And checks and has sufficient comfort on the VAT treatment applicable to output and input transactions.

We recommend that procedures be put in place to ensure that the above points are verified periodically to ensure Luxembourg entities and funds follow good VAT governance.

VAT on the remuneration of independent directors of investment funds and of their management companies

Circular-letter issued by the VAT Authority [9]

As a background, the VAT Authority issued a circular letter on 30 September 2016 with the aim of clarifying the position for directors and companies receiving services from directors.[10] The VAT Authority also published answers to "Frequently Asked Questions" [11] on a dedicated page of its website.

In this circular letter, the VAT Authority confirms that directors' fees fall within the scope of VAT irrespective of whether the director is a company or a private individual.

When the place of the supply of the services provided by directors is Luxembourg, the directors' fees are normally subject to the standard VAT rate of 17%.

The circular letter provides exceptions to the principle of taxation when the director is an employee representing his employer on the board [12] and when the director supplies his or her services in the context of an honorary activity remunerated by "jetons de presence." [13]

Circular-letter issued by the direct tax authority [14]

In February 2017, the direct tax authority issued a circular-letter as regards the treatment of "tantièmes" from a direct tax purposes [15]. This circular letter refers to the circular letter issued in September 2016 by the VAT Authority and reminds that directors' fees fall within the scope of VAT.

This circular letter specifies that when the "tantièmes" are subject to VAT, the withholding tax due by the company has to be determined based on the amount of tantièmes VAT excluded. It also specifies that when the VAT on tantièmes is not deductible for the company from a VAT point of view (in full or partially), the tantièmes and the non-recoverable VAT are both not deductible for direct tax purposes.

No reference to the fund management VAT exemption (Article 44,1,d) of the Luxembourg VAT Law)

These two circular letters do not confirm that the application of the fund management VAT exemption can apply to directors on the boards of qualifying investment funds (SICAVs, FCPs, SICARs, AIF, securitisation vehicles, pension funds) and/or to directors on the boards of management companies managing these funds.

However, the VAT exemption should not be challenged to the extent that the directors' functions are specific and essential to the management of these funds.

Since the two circulars do not provide clear criteria or conditions that need to be met to apply this specific VAT exemption, an ad hoc working group has been set up with representatives of two professional associations, ALFI [16] and ILA [17]. In March 2017, this working group issued joint recommendations dealing with VAT on the remuneration of directors of qualifying investment funds and their management companies.[18]

ALFI and ILA recommendations

The document issued by the representatives of ALFI and ILA deals essentially with the case of directors of management companies and provides guidelines to determine the proportion of the remuneration which relates to:

- The management of the management company itself (which cannot benefit from the VAT exemption and should be fully taxable).
- And the proportion of the remuneration that relates to the management of the funds (which could benefit from the VAT exemption if the tasks performed are specific and essential to the management of the funds).

The recommendations describes what the roles and responsibilities of a fund director generally are and provides an indicative list of tasks that are typically performed by a director of a management company. The tasks that tend to be specific and essential to the management of funds (and could thus be VAT-exempt) are identified. The recommendations also identify the tasks that according to the ad hoc working group are not eligible to the VAT exemption either because they relate to the funds (but they are not specific and essential to their management) or because they relate to the management company.

The guidelines thus represent only the view of the ad hoc working group and do not bind the tax authorities.

Final remarks

With these new rules, it is ever-critical for directors, managers and any persons in charge of daily management to get comfortable with the VAT situation of the legal entities they manage and with their own VAT obligations where applicable.

Ongoing VAT compliance monitoring should now be part of good governance and an item on the board agenda if this was not the case before. Together with these new rules, the Tax Reform also introduced higher penalties for non-compliance with the VAT obligations and two new criminal offences for aggravated tax fraud and tax swindling.

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1 Loi du 23 décembre 2016 portant mise en œuvre de la réforme fiscale 2017 publiée au Mémorial A.

2 Articles 67-1 to 67-4 of the Luxembourg VAT Law.

3 Administration de l'Enregistrement et des Domaines

4 Rapport d'activité 2016 et objectifs 2017 de l'Administration de l'Enregistrement et des Domaines http://www.aed.public.lu/administration/rapports/Rapport-annuel-AED-2016.pdf, last downloaded on 9 May 2017. Link here.

5 Article 67-1 of the Luxembourg VAT Law.

6 German case law on the liability of managers for direct taxes is relevant due to the common origin of the applicable German and Luxembourg legal provisions.

7 Law of 10 August 1915 on commercial companies, as amended.

8 Article 67-2 of the Luxembourg VAT Law.

9 Administration de l'Enregistrement et des Domaines.

10 Circular 781 of 30 September 2016, Activité d'administrateur de sociétés (http://www.aed.public.lu/actualites/2016/09/Circ-781/Circ_-N_781-du-30_09_2016.pdf, last downloaded on 9 May 2017). Link here.

11 http://www.aed.public.lu/actualites/2016/09/Circ-781/Administrateurs-FAQ/index.html, last downloaded on 9 May 2017. Link here.

12 In that case, the VAT authority is of the opinion that the director is not acting independently and is not a taxable person for the purpose of VAT, his employer has this capacity and would be liable for VAT.

13 In that case, the VAT exemption provided by Article 44,1,w) of the Luxembourg VAT Law can apply.

14 Administration des Contributions Directes.

15 Circular LIR n 45/2 – 152/1 – 168/1 of 14 February 2017, Retenue d'impôt sur les tantièmes (http://www.impotsdirects.public.lu/content/dam/acd/fr/legislation/legi17/LIR45_2_14022017.pdf, last downloaded on 10 May 2017). Link here.

16 Association of the Luxembourg Fund Industry.

17 Institut Luxembourgeois des Administrateurs.

18 See http://www.alfi.lu/sites/alfi.lu/files/VAT-on-remuneration-of-directors-of-UCIs-and-their-management-companies-FINAL.pdf, last downloaded on 14 March 2017. Link here.

REGULATORY DEVELOPMENTS: ILLIQUID ASSETS AND OPEN-ENDED FUNDS

Since the financial crisis, regulators and central banks have been continuously monitoring the health of the financial system, and, as the life blood of the system, liquidity is particularly important. The regulatory spotlight has now fallen on the asset management sector and open-ended funds, prompted, in part, by the impact on open-ended property funds following the result of last year's EU referendum in the UK. In this article, we consider the recommendations of the Financial Stability Board (FSB) in its policy recommendation paper (PRP)[1] and the views of the Financial Conduct Authority (FCA) as set out in its discussion paper (DP)[2] on illiquid assets and open-ended funds, and consider some of the implications for asset managers.

FSB policy recommendations

The FSB is an international body and as such its macro-prudential recommendations are directed at the International Organization of Securities Commissions (IOSCO), European and national regulators. While not targeted at asset managers directly, the recommendations are still useful early warnings of the direction of regulatory travel.

Importance of the asset management sector

According to the FSB, global assets under management (AUM) have risen from USD53.6 trillion in 2005 to USD76.7 trillion in 2015 (which equates to 40% of the global financial system's assets). As a result of this growth, the FSB began work in March 2015 to identify specific areas of vulnerability in the asset management sector, reporting its initial findings six months later. The report highlighted five key areas:

- Mismatch between liquidity of fund investments and redemption terms and conditions for fund units (liquidity mismatch).
- Leverage within investment funds.
- Operational risk and challenges in transferred investment mandates in stressed conditions.
- Securities lending activities of asset managers and funds.
- And potential vulnerabilities of pension funds and sovereign wealth funds.

The FSB then carried out further analysis in respect of these five areas and issued its policy recommendations in January of this year. Nine of the 14 recommendations aim to address liquidity mismatch issues, making it clear that this area is of importance to the FSB.

FSB liquidity mismatch recommendations

The FSB's liquidity mismatch recommendations fall into four broad categories.

- **Recommendations to address the lack of information and transparency regarding liquidity mismatch:** Regulatory authorities should consider collecting more data on the liquidity profile of open-ended funds and reviewing existing reporting requirements to ensure that they are receiving enough detailed information to allow them to monitor such funds properly and that such funds are disclosing enough information to investors regarding liquidity risk.
- **Recommendations to improve liquidity risk management tools in normal times:** Regulatory authorities should issue rules or guidance that a fund's assets should be consistent with its redemption terms throughout the life cycle of the fund and not just on establishment. In addition, authorities should widen the availability of liquidity management tools to open-ended funds to help funds meet redemption requests even under stressed market conditions

(for example, considering the introduction of notice periods) and reduce first mover advantage. Authorities should also review their guidance on liquidity stress testing.

- **Recommendations on the adequacy of liquidity risk management tools for stressed circumstances:** Regulatory authorities should promote clear decision-making processes for the use of liquidity risk management tools during periods of exceptional stress and should consider whether they ought to direct managers specifically to use such tools during periods of stress. Such tools could include swing pricing and potentially redemption fees.
- **Recommendations on system-wide liquidity stress testing:** Regulatory authorities should consider system-wide stress testing to test the resilience of the wider financial markets to potential collective selling by funds and other investors.

As mentioned above, the FSB directs its recommendations primarily at IOSCO, which is currently working on updating its liquidity guidance and has been asked to complete this by the end of this year. A consultation paper is expected to be published by IOSCO later this year, which should flesh out the FSB's recommendations and give further guidance to the industry.

FCA Discussion Paper

The FCA has also been considering liquidity issues in open-ended funds. Reflecting the FCA's "forward-looking approach to assessing potential and emerging harm", the DP reviews current liquidity management tools and suggests proposals for possible improvements [3] The FCA is keen to receive industry input on these proposals. In terms of the application of the DP, while its focus is on authorised funds and their regulatory framework, its proposals to improve liquidity management are relevant to unauthorised funds as managers and depositaries of such funds are likely to be regulated themselves.[4]

Brexit and open-ended property funds

The FCA had already strengthened its supervision of the largest property funds prior to the Brexit referendum. The initial effect of the referendum result was the enhanced supervision by the FCA of 26 open-ended funds investing in real property.[5] The FCA also arranged a roundtable of the relevant funds in July 2016, where a general suspension of property funds was discussed, although ultimately this was not implemented on the grounds that such a move could lead to further loss of confidence in the market. In practice, each fund manager was allowed to decide which steps were appropriate for it to take acting in the best interests of the fund's investors. A total of six open-ended funds were suspended for varying periods of time, but it is important to remember that these funds were all daily-dealing funds (and that the other 20 remained open). The first suspended fund to resume dealing did so at the end of September 2016, and all suspended funds had resumed dealing by December 2016. The FCA's view that there was no overall contagion across asset classes, and the fact that the relevant funds managed the situation effectively indicates that fund managers already have access to appropriate tools and that they can use them in a proportionate manner.

Nonetheless, from the regulator's point of view, these events highlighted concerns about the appropriateness of open-ended funds investing in illiquid assets while offering frequent redemption points to investors (particularly retail investors), and hence was another factor in the FCA deciding to carry out a review.

Current liquidity risk management tools

Open-ended regulated funds and their managers are already highly regulated. UCITS funds, for example, are only allowed to invest in liquid assets and therefore by definition should not usually be illiquid. Other authorised funds, such as non-UCITS retail schemes (NURS), are subject to extensive rules regarding the type of assets they can hold, which should also ensure a high level of liquidity and furthermore managers should already be aware of their duty to manage liquidity risk as required under AIFMD.

Current liquidity risk management tools available to fund managers include:

- Managing the portfolio structure well and ensuring an appropriate liquidity buffer.
- Using a sliding scale of redemption charges.
- Having a diversified investor base and understanding investors' likely behaviour in times of stress.
- Having an appropriate redemption and dealing arrangements, including the ability to defer or limit redemptions in certain situations.
- Having appropriate asset valuation tools (such as fair value pricing [FVP] and anti-dilution measures).
- And suspending dealing.

These tools have certain advantages and disadvantages, depending on the circumstances. The FCA emphasises that there is significant discretion available as to which tools a manager chooses to use. This flexibility is useful since it allows fund managers to address liquidity risk management in a proportionate way. However, flexibility also raises concerns for the regulator: there is a risk that fund managers could take inconsistent approaches which could mean investors are not adequately protected. In light of this, the FCA has proposed developing its rules and guidance in this area. At this stage, the FCA is not proposing to ban open-ended funds holding illiquid assets or to prevent retail clients from buying units in open-ended property funds, and this has been welcomed by the industry.

Investor-related proposals

Mixing retail and professional investors
While the majority of authorised open-ended property funds are NURS and therefore open to retail investors, in reality the DP reports that professional investors hold large holdings in such funds. The FCA is concerned from a liquidity management context as to how appropriate this mix of investors is, in particular whether retail investors may be disadvantaged by a lack of expertise and lack of access to the equivalent level of information as professional investors.

The FCA asks in the DP whether it may be beneficial to separate out investor types, for example by requiring (rather than allowing) different classes for different types of investor. It would then be easier for managers to apply different dealing criteria to retail clients (who should continue to have access to frequent dealing points as their smaller holdings ought not unduly affect a fund's liquidity) and professional clients (whose larger holdings may have a greater impact on the fund's liquidity and their redemptions may benefit from being managed over a longer period). This proposal would have a potentially significant impact on fund managers. While many funds already have different fund classes for retail and professional investors, to make this obligatory would involve considerable work for fund managers and administrators.

Furthermore, while the proposal appears to protect retail investors, it arguably goes too far and gives retail investors a first-mover advantage. As a result, it is conceivable that such funds will become less attractive to professional clients. It could also have unintended consequences, such as encouraging retail clients to engage in short-termism (which is not appropriate for such investments) or to deal too early, and it could also precipitate a run on the fund.

> **“The FCA is considering whether to strengthen the rules on portfolio structure, including a possible cap on the proportion of assets held as illiquid assets or a minimum amount of the fund required to be held in cash.**

Diversity of investors
The FCA is also considering whether there should be a requirement on fund managers to ensure their investor base is sufficiently diverse, for example as set out in the current Property Authorised Investment Fund (PAIF) regime. This regime requires managers to prevent certain investors from holding more than 10% of the fund. However, this would require significant information gathering and policing of investors by fund managers, which could cause practical difficulties as many holdings are via intermediaries, for example platforms. Given the high level of regulation of authorised funds, and the very rare occasions on which it has been necessary to take decisions to suspend such funds, it is difficult to see a strong justification for such limits.

In terms of identifying underlying investors, it's worth noting that while current rules give managers the power to gather information on underlying unit holders from intermediate

holders, it is easier to get the information from some intermediaries than others. Further new requirements under MiFID II, which come into effect on 3 January 2018, will have the effect of increasing the flow of information between funds and distributors regarding investors, so there does not appear to be a strong case for further rules at present, at least until MiFID II changes have bedded down.

Portfolio structure and liquidity buffer

The FCA is considering whether to strengthen the rules on portfolio structure, including a possible cap on the proportion of assets held as illiquid assets or a minimum amount of the fund required to be held in cash.

The concern is whether such rules or guidance would be proportionate to the risk and whether this guidance would in effect micromanage a fund's asset allocation. Such measures could have a significant impact on an investor's ability to choose to invest in the illiquid asset class involved. As with the concerns surrounding the mixing and separation of retail and professional investors discussed above, requiring a material cash buffer could also create a significant first-mover advantage for investors who exit a fund at the beginning of a period of stress.

Similarly, the FCA also considers requiring funds to hold more diversified assets, but this is likely to materially affect investor choice. Investors wishing to invest in a real property fund want that fund to hold real property, not a balanced range of assets.

The idea of implementing a system of liquidity "buckets" as adopted by the U.S. Securities and Exchange Commission (SEC) as part of its liquidity classification scheme for highly liquid funds is also referred to in the DP.[6] Under the SEC rules, fund managers are obliged to classify each fund holding into one of four liquidity buckets based on how quickly each asset can be liquidated. Fund managers need to consider, and document their consideration of, appropriate factors to determine an instrument's liquidity. The liquidity of each holding must also be reviewed on a monthly basis. Given that the DP deals with funds that hold illiquid assets, the proposals do not easily read across, and the FCA itself does not regard this proposal as practical.

Asset valuation and anti-dilution measures

FCA rules and guidance do not currently deal with FVP for non-financial assets, such as real property, in any detail, so the FCA is considering whether further guidance in this area would be helpful. This could be especially useful for fund managers in times of stress when applying discounts to the redemption price of units in a fund.

However, the FCA also acknowledges that such circumstances call for finely balanced judgement by the manager. One needs to avoid "punishing" an investor who wants to leave the fund. On the other hand, early leavers may still benefit from first-mover advantage should a fund subsequently be suspended as they would have already redeemed their units.

While FVP guidance could be helpful, any such guidance will need to be carefully considered to ensure that it does not cause unintended consequences.

The timing of the FSB's PRP and the FCA's DP is helpful to the industry insofar as the FCA is clearly asking for wide-ranging input from the industry and allowing for feedback on any points of concern and wider global regulatory trends.

Deferring and limiting redemptions

Many funds investing in illiquid assets include provisions in their documentation allowing the manager to defer redemptions where a redemption request is classed as a "large" deal (10% of the size of the fund, for example). However, currently the FCA rules only allow NURS redemptions to be deferred until the next valuation point, and it is not clear whether this can be done on a rolling basis, which in the case of a daily dealing fund is not particularly helpful. The FCA is also considering whether to require managers to include powers such as deferred redemption in scheme documents so that they can be used in exceptional circumstances. There is currently little guidance on these powers and the Investment Association in the UK is working with fund managers to ascertain what rule changes and additional guidance would be helpful.

The FCA is also looking at redemption frequency and the use of notice periods, considering, for example, introducing rules to prevent funds with illiquid assets offering frequent redemption points. This approach could be helpful for managers of funds investing in illiquid assets, but it is quite a significant change for retail authorised funds where the use of notice periods is very rare and investors are used to being able to access their money quickly. Furthermore, requiring funds to have fewer dealing points has its own issues, as by reducing redemption points, multiple orders may need to be dealt with in a very short time span, which can create difficulties for the manager, although the FCA notes that there are some operational solutions to this (for example, by using a queuing or pooling system). In addition, as the FCA acknowledges, to be eligible for inclusion in an Individual Savings Account, there needs to be at least fortnightly redemptions, which is another issue to be considered.

Direct intervention by the FCA

The FCA already has extensive powers to intervene in the activities of authorised firms, including requesting such firms to take specific actions such as suspend dealing. The FCA did not use these powers in the aftermath of the 2016 referendum because it did not think it was warranted. While certain fund managers did decide to suspend dealing at that time, the FCA believes this indicates that the market was continuing to function in an orderly manner and did not require its intervention. However, the FCA is aware that there could be instances when a manager might be reluctant to be the first to suspend dealing (for reputational reasons, perhaps).

Unless the feedback suggests otherwise, the FCA appears to be reluctant to increase its use of direct intervention powers, as it considers there are significant risks associated with such actions. While an individual fund manager deciding to suspend dealing may be considered indicative of an orderly functioning market, a wider intervention by the regulator could result in the sort of financial panic the regulator is trying to avoid.

Enhanced disclosure

The FCA believes there is a risk that potential liquidity issues are not, in their current form, adequately disclosed to investors. While information on potential liquidity issues and how the manager can deal with such issues are set out in the fund's prospectus, in reality the FCA is aware that not many investors request to see the prospectus and some authorised fund managers' prospectuses are not easily available. Annual and half-yearly reports are another source of information, but such accounts may be published months after the events that caused concern.

The FCA is also concerned that presale information for funds is not standardised (except for UCITS). However, it is arguable that this will be largely addressed through the introduction of the PRIIP KIDs (at least for retail clients).[7] These documents will require the liquidity risk to be addressed in a specific section.

While there are good arguments for enhanced disclosure on liquidity issues, it is also worth remembering that investors should not be unduly put off investing in longer-term funds.

Secondary market provision

The final suggestion made by the FCA in its paper is whether more should be done to encourage a secondary market as an alternative redemption route, particularly during periods of stress. However, under normal circumstances, it is usually straightforward to deal through a manager, and under stressed market conditions, it is not likely that the secondary market would offer significantly more liquidity while it would add to the cost and administrative burden of dealing.

Conclusion and next steps

The DP and the PRP demonstrate the continuing regulatory interest in liquidity across the financial sector. The timing of the FSB's PRP and the FCA's DP is helpful to the industry insofar as the FCA is clearly asking for wide-ranging input from the industry and allowing for feedback on any points of concern arising from both papers and wider global regulatory trends (such as the developments in the US). In particular, it may be worth considering whether the recommendations for increasing amounts of data (whether provided to the manager or also available to the regulator) suggested by the FSB is necessary or proportionate in the UK and indeed the EU. The asset management sector will be required to generate and share significant amounts of additional data as a result of MiFID II, and there is a strong argument that regulators should make the best use of the data they will have access to as a result of such changes before considering whether to put managers under further reporting obligations.

The FCA is expected to issue a response later in the year, and it will be interesting to see the extent to which the FCA takes on board the industry feedback it receives. If the FCA does consider amending its rules or guidance, it will have to issue a consultation paper, which will be another opportunity for industry input. IOSCO is also due to have completed its liquidity review and to have carried out the work requested by the FSB by the end of 2017, so we should expect a further paper on the topic. While many asset managers will have dedicated significant resources to high-profile regulatory projects such as MiFID II and PRIIPs, time will also be required for any changes to liquidity risk-management policy that may require implementing.

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[1] FSB "Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities," 12 January 2017.

[2] FCA DP 17/1 "Illiquid Assets and Open-Ended Investment Funds," February 2017.

[3] As set out in FCA's Business Plan 2017/2018: see https://www.fca.org.uk/publication/business-plans/business-plan-2017-18.pdf, last downloaded on 27 April 2017. Link here.

[4] As a result of the Alternative Investment Fund Managers Directive 2011/61/EU.

[5] Of these 26 funds, seven were unauthorised funds chosen because their investors included intermediaries with substantial exposure to underlying retail customers, highlighting the extent to which the FCA will use its regulatory reach to protect retail investors.

[6] SEC "Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs and Permit Swing Pricing," October 2016.

[7] Packaged Retail and Insurance-based Investment Products Key Information Document (PRIIPs KID).

MIFID II AND ITS IMPACT ON FUND MANAGERS IN THE NETHERLANDS

The 2008 global financial crisis forced the European Commission (EC) to re-evaluate whether the Markets in Financial Instruments Directive (MiFID) was fit for purpose, and it was decided that the directive's key principles – a regulatory framework centred on shares and regulated markets – needed to be updated to take into account a more complex market characterised by increasingly diverse financial instruments and methods of trading. As a consequence, as of 3 January 2018, MiFID will be replaced by a recast Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR).

Given it is a directive, Member States need to take steps to transpose the requirements of MiFID II into their own national laws by 3 July 2017. As a regulation, MiFIR will have a direct effect (i.e. no implementation necessary) as of 3 January 2018. In the Netherlands, MiFID II will be implemented into the Act on Financial Supervision (*Wet op het financieel toezicht*, AFS).

The Dutch Ministry of Finance (the Dutch Ministry) had previously consulted on the implementation of MiFID II into the AFS in June 2015[1] and further published its implementation proposal in October 2016.[2] In addition, the Dutch Ministry is currently consulting on the implementation of MiFID II and its Level II rules into lower decrees such as the Decree on conduct of business rules AFS (*Besluit Gedragstoezicht financiële ondernemingen Wft*, BGfo).[3]

Below we take a look at what we consider to be MiFID II's key points and more specifically who will be affected.

What are the key points?

There are four key points to consider.

The first point concerns the strategic implications of the new EU legislation and its impact on group corporate structures due to changes to the exemptions set out in MiFID II and new provisions in MiFID II and MiFIR relating to non-EU firms wishing to do business in the EU. The Dutch minister of finance proposes that, in principle, non-EU firms that provide investment services or undertake investment activities in the Netherlands need to be licensed. If the services are provided to non-professional and professional clients, a branch will need to be established in the Netherlands. Until the EC's equivalence determinations, there will be an exemption and thus no licence or branch obligation for non-EU investment firms that are established in the US, Australia and Switzerland and that provide their services to professional clients in the Netherlands or undertake investment activities such as dealing on own account in the Netherlands.

The second point, meanwhile, concerns dealing effectively with the new markets requirements and changed market structure. You must consider which markets you will continue trading, or become a market maker, in, as, for example, a new type of trading venue, the organised trading facility (OTF), will be created to capture multilateral trading in non-equity instruments that does not currently take place in regulated markets (RM) or multilateral trading facilities (MTFs). There is also a new trading obligation to trade certain listed shares on an RM, an MTF or a systematic internaliser (SI) (see below), as well as the introduction of a requirement to trade certain classes of derivatives on a RM, MTF or OTF. There will also be new trading rules for equity and derivative instruments, new pre- and post-trade transparency obligations for equity-like and non-equity instruments, extended transaction reporting requirements and a regulatory framework for consolidated trade data. There has been some discussion whether the transaction reporting obligation also applied to fund managers. The Dutch Authority for the Financial Markets was of the opinion that it was, but the Dutch minister of finance has confirmed

Four key points to consider: the impact on group corporate structures, new markets requirements, investor protection, and regulatory interest about firms' implementation plans and projects.

in its implementation proposal of October 2016 that the transaction reporting obligation does not apply to fund managers.

Investment firms dealing on own account by executing client orders outside a trading venue — known as SIs — will be subject to enhanced firm quote obligations. There are also new requirements for firms engaged in algorithmic and high-frequency trading, new obligations for trading venues concerning circuit breakers and rules relating to minimum tick sizes and a ban on broker crossing networks for equities. New position limits, position reporting and position management powers are introduced for commodities.

The third point to consider is that, while the headlines may have focused on the new markets requirements, MiFID II and MiFIR also make many important amendments to MiFID's conduct of business rules, which snowball into significant regulatory reform, including amendments to terms of business. The new conduct of business requirements include:

- Strict restrictions on independent advisers and portfolio managers making or receiving fees, commission or non-monetary benefits. The Netherlands already has rules on receiving or paying commission which are more strict than under the current rules. Therefore, it is expected that the MiFID II restrictions will not have a big impact on investment firms that already operate in the Netherlands.
- Enhanced product approval process rules.
- New supervisory powers for ESMA and Member State regulators to ban a financial product.
- And new requirements relating to best execution, including that an investment firm must summarise and publish annually its top five execution venues by trading volume for each class of instrument and information on the quality of execution obtained.

The fourth and last point to keep in mind is that investment firms may be under pressure from regulators that ask questions about implementation plans and projects.

Who is affected by it?

Pretty much everyone involved in financial services will be affected. MiFID II and MiFIR will underpin the provision of investment

services and activities across, and into, Europe, in terms of both how trading is carried on and how firms organise and conduct themselves. They will affect both the wholesale and retail sides of the industry for securities and derivatives. They should also not be seen as solely European measures, as their collective effect will be far-reaching and influence non-EU firms that have or are seeking a European client base.

When will MiFID II have an impact on fund managers?

Managers of UCITS and alternative investment funds (AIFs) will be affected by the rules laid down in MiFID II if they have extended their fund manager licences to also provide investment advice and/or individual portfolio management. In addition, AIF managers may also provide the investment service receipt and transmission of client orders.

If the licence of the fund manager also allows the provision of the aforementioned investment services, a seemingly limited amount of rules apply. However, these rules will be more detailed and prescriptive under MiFID II. Therefore, the impact should not be underestimated. The rules that will apply are articles 15, 16, 24 and 25 of MiFID II. These articles cover the minimum own capital requirement, the organisational requirements, general principles on the duty of care and the provision of information, and the rules on suitability and appropriateness that apply. Below we look at some of the most important amendments.

There will be a distinction between independent or non-independent investment advice

Under the current rules there is no explicit distinction between independent or non-independent advice. However, MiFID II requires that by giving independent advice, fund managers should consider a sufficiently wide and diverse range of financial instruments available on the market. In addition, the financial instruments considered should not be provided solely by the firm or closely linked entities, and no inducements should be paid or received.

There are more detailed rules on the selection process if a manager wants to provide independent advice. The selection process should assess and compare a range of sufficiently diverse financial instruments. This means that a diversified selection of instruments (by type, issuer or product provider) should be considered. The number and variety of instruments considered should be proportionate to the scope of services offered and should be adequately representative of those available in the market.

Furthermore, the quantity of financial instruments issued by the firm or entities closely linked to it should be proportionate to the total amount of instruments considered and the criteria for comparing various financial instruments should include all relevant aspects, and they should ensure that neither the selection of instruments that may be recommended nor the recommendations are biased.

It remains possible for fund managers to focus on certain classes or a specified range of financial instruments. However, additional restrictions in relation to marketing apply. Investors should be able to easily identify a preference for the specified classes or specified range of financial instruments and get a confirmation that the product is suitable for such investor.

The rules on product governance will not apply directly to fund managers: however, be aware...

The rules of the new EU-wide product governance regime in principle do not apply to fund managers. Distributors of the funds that are captured by these new rules will expect the fund managers to at least determine or assist to determine the target market of the funds. The detailed rules on product governance will be implemented into Dutch law in the BGfo. Based on the explanatory memorandum to the consultation document, it appears that the Dutch minister of finance does not intend to gold-plate the provisions set out in the EU Delegated Directive. However, there are some text inconsistencies. We expect that these will be corrected in the final proposal.

Intermediaries or distributors will not be able to sell the manager's products unless the fund manager provides the required product information. In this context, the information contained in UCITS KIIDs and PRIIPs KIDs does not meet the product information requirements under MiFID II, neither on the determination of the target market, nor on the costs and charges that an intermediary or distributor must provide under the MiFID II rules.

By way of background, the new requirements – applicable to the manufacturer and to the distributor – mean that there is a clear obligation placed on the manufacturer to ensure that distributors clearly understand the nature of the product and how it should be sold to the appropriate customer. One way of doing this is for the manufacturer to provide appropriate training to those involved in the distribution chain.

Product distributors must also regularly review the products they market to assess whether they remain consistent with the needs of the identified target market and whether the distribution strategy remains appropriate.

Is it still possible to sell your funds on an execution-only basis?

The existing list of financial instruments where no appropriateness analysis is required will be amended, as shown in the points captured below, narrowing, in effect, the scope of execution-only business.

What can be sold on an execution-only basis?

- Shares admitted to trading on a regulated market, an equivalent third-country market or a multilateral trading facility, where these are shares in companies (except shares in non-UCITS collective investment undertakings and shares that embed a derivative).
- Bonds and other forms of securitised debt admitted to trading on a regulated market, an equivalent third-country market or a multilateral trading facility, and money-market instruments (except those that embed a derivative or incorporate a structure that makes it difficult for the client to understand the risk involved).
- Shares or units in UCITS (except structured UCITS).
- Structured deposits (except those that incorporate a structure that makes it difficult for the client to understand the risk of return or the cost of exiting the product before term).
- And other non-complex financial instruments.

To determine whether the fund is non-complex two additional criteria, in addition to the current four criteria, as laid down in the MiFID Implementing Directive, needs to be taken into account, namely:

- That the instrument does not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile (i.e. investments that incorporate a right to convert the instrument into a different investment).
- And that the instrument does not include any explicit or implicit exit charges that have the effect of making the investment illiquid.

Units in a structured UCITS and shares that embed a derivative will automatically be considered complex, as will certain debt and money market instruments and structured deposits. Furthermore, shares or units in AIFs are automatically considered to be complex.

Do the cost disclosure rules apply?

MiFID II increases the amount of information that needs to be disclosed to investors. For fund managers, it is important to note such new obligations will affect them directly if they provide investment services to their clients. However, even if fund manager's do not provide investment services, they will be indirectly impacted as producers of financial instruments. This is caused by the fact that they will be required to provide sufficient information to the investment firms subject to MiFID II with which they have a business relationship in order for such firms to comply with the more detailed rules on cost disclosure. For instance, the KIID for UCITS does not contain all the information required by MiFID II, particularly with regard to the cost of transactions.

Conclusion

We experience that not all investment firms (and fund managers) have started their MiFID II implementation project properly. Even though for some investment firms (and fund managers) the amended rules seem minor, the devil is in the detail! We would strongly recommend to not waste any more time as the implementation deadline is approaching and we don't expect any extension on the 3 January 2018 deadline.

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1 Please see https://www.internetconsultatie.nl/mifidii.

2 Please see https://www.rijksoverheid.nl/documenten/kamerstukken/2016/10/25/wetsvoorstel-wet-implementatie-richtlijn-markten-voor-financiele-instrumenten. Link here.

3 Please see https://www.internetconsultatie.nl/mifidii_besluit.

THE ROUTE TO LOWER KYC COSTS

Know your customer (KYC) and due-diligence procedures remain some of the most costly regulatory requirements that the Luxembourg fund industry, and more broadly businesses across the financial sector, face today. Yet this is in spite of the decade and a half that has passed since global lawmakers began to put in place rules to fight money laundering and terrorism financing. In this article, we explore what considerations fund industry participants might take onboard to better help them move towards decreasing the rising complexity and associated costs of such bottom-line concerns.

Challenge for all

Banks, investment funds, family offices, insurance companies, holding companies, service providers and the rest all face a daily battle to comply with KYC and anti-money laundering and counter-terrorist financing (AML and CTF) duties and assure themselves that clients are not using the financial system for illegal activities. Making a mistake in judgement or having lax procedures in place could lead a corporation to founder.

KYC regulations also make it harder and more expensive to serve clients, the vast majority of whom have no criminal intentions. It is frustrating for clients and sales teams that a range of identity documents are required when onboarding each new customer. This time-consuming, labour-intensive process is complex and prone to error, particularly in a major international financial centre like Luxembourg with clients from across the globe.

Waste = potential savings

It is ironic that many investment funds have to make the same checks on the same clients. Often this results in each of the counterparties having to supply the same information several times. These would include, among other information, proofs of identity and addresses for individuals and certificates of incorporation and memorandums of association for corporates. By way of illustration of the complexity and cost, more than 60 documents and data points can be required by asset managers related to KYC for each investor.

The good news is that where there is waste, savings can be made. For example, a recent report by Deloitte pointed to the potential for cutting EUR180 million in costs by correcting inefficiencies in KYC handling and due diligence.[1]

KYC utility: a game changer

A mutualised KYC utility is a promise for a faster, economical solution. Such centralised utilities come in many forms, and have been helping the financial services industry to be more efficient and accurate for decades. Stock exchanges and clearing and settlement houses are long-standing examples where market players share information for mutual benefit through a trusted central counterparty. These bodies also encourage the harmonisation of standards and procedures, further encouraging efficiency and lower costs.

Individual and corporate clients sharing data in a highly secure, centralised utility would work in a similar way for KYC. It would mean that investment firms would no longer have to conduct duplicate tasks in-house, but it would also improve quality, as a more rounded picture of each client could be created. Changes to international watch-lists of criminals, terrorists and politically exposed persons would be taken into account by the utility. This information would prevent firms from onboarding inappropriate people, and alerts would warn of a change in an existing client's status.

Costs down, accuracy up

Accuracy would increase as costs fall. As well, financial industry players would cut the risk of inadvertently breaching fast-changing rules. Communication with regulators would also be improved as systems would be aligned and reporting automated. Businesses could focus more on their core activities of serving their trusted clients. And regulators and governments would appreciate the greater efficiency across the whole industry.

Complexity would be reduced too as web of connections become streamlined. For example, if 10 businesses are each working with the same 10 clients using point-to-point connections, each of the businesses would request documents from each of the clients. This would involve sets of documents being shared 100 times. However, with a universally trusted central counterparty, the number of communications would be cut to 20, as documents only need to be sent to the utility.

Unlock innovation

A utility, moreover, would have the resources to be highly innovative, such as through the development and use of cutting-edge financial technologies (FinTech). For example, tailor-made algorithms are needed to search huge in-house databases while trawling for publicly available information. New technologies are rich with promise, but few individual companies have the size and reputation necessary to fully unlock this potential.

Several KYC utilities have emerged around the world, but none addresses the specific needs of the Luxembourg fund industry. Nowhere else is so focused on international markets, meaning that systems in Luxembourg have to cope with multiple regulatory regimes, different standards and a range of languages. Luxembourg's regulatory environment is also unique in the sense that Luxembourg funds are distributed cross-border in 70 countries, and requires specialist treatment, as distributing cross-border means that another layer of complexity is added in terms of the local regulations to be adhered to where the fund is distributed.

Assessing the fund industry appetite

A KYC utility for the whole fund industry sector in the Grand Duchy is being discussed by a working group of local market players. This innovation should take care of the execution of rules related to know-your-customer, know-your-customer's-customer and know-your-distributor protocols. At its heart, a complete document repository is required. This will enable a seamless exchange of information about the probity of each client between relevant participants. It will make life easier for investors, as they will only need to prove their good standing once with the central utility.

Moreover, to be of full benefit to the sector, a centralised market utility should add value services such as a risk-rating engine to add context to the information. This would speed the due-diligence process during onboarding and give real-time updates on any changed circumstances of existing clients. Processes that could be accommodated include customer identification, initial risk assessment, due diligence and other forms such as on-site (performed at client offices) and the know-your-distributor checks, risk scoring, reputation risk management, AML/CTF country risk assessment and so on. It could also facilitate straight-through processing of regulatory reporting.

Even though it has the potential to become a powerful tool, a central utility will not necessarily solve every question, however. It wouldn't absolve financial professionals from ultimately making decisions about client acceptance, for instance, and it would neither be able to monitor, nor report suspicious, transactions.

Fintech promises major strides forward. For example, a digital identity is a representation of a person's real-world persona in electronic format.

Different technology options

So, how, in technical terms, might the KYC utility work? Existing technologies and systems would do the job well as many software companies already develop sophisticated tools. Using innovative systems, a utility would work much like a well resourced compliance department. Constant cross-checking internally, with clients and with regulators, would keep the information up to date and accurate.

Longer term, FinTech would make the utility more efficient and effective. For example, not only online news from mainstream sources but also blogs and social media provide a host of information about individuals and companies. Not all this information is reliable, but best practice suggests this information needs taking into account. Tools are being developed that scour the internet for information about individuals, with algorithms then sorting this data. For most internal KYC departments, such tools are nice but perhaps too costly to have. A large utility, however, would have the necessary resources.

Digital ID potential

Beyond marginal gains such as these, FinTech promises major strides forward. For example, a digital identity is a representation of a person's real-world persona in electronic format. Creating a system of secure, trusted and accepted digital identities would go a long way to solving the central KYC challenge of being sure that a counterparty is who they say they are. A customer-centric system would also open the way to creating a range of new, innovative services.

Digital identity assurance has been an aspiration for governments, regulators and the private sector for a number of years. After all, having a unified system would be useful in financial services, healthcare, national security, citizenship documentation, driving licences, online retailing or even proving your age in a bar. Currently, internet users have multiple digital identities for each platform. Managing identities across applications and platforms is becoming increasingly challenging and cumbersome.

Digital ID assurance has become a main FinTech theme, attracting substantial R&D funding globally as a result. Public authorities around the world have also sought to promote the idea in many countries. However, few of the projects have made progress beyond limited niches.

This is a deceptively simple idea, but the practicalities of creating convenient, quick and secure solutions are more complex. Privacy, data protection, security and consent mechanisms are at the centre of public debates and technological challenges. Could a utility be the way to open the door to digital identity assurance schemes designed specifically for financial sector businesses generally or Luxembourg specifically?

Blockchain: the new opportunity

Distributed ledger technology could offer a solution for this and other financial sector data-processing challenges. Blockchain technology was developed to power cryptocurrencies, and increasingly it is seen as a secure, tamperproof way to share any type of data. The blockchain uses distributed ledger technology (DLT) to track everything from ownership of assets through to identities. Anyone with permission can update and access data on the distributed ledger, with all users able to see who has changed what, when, and by how much. Counterparties could keep these ledgers up to date in real-time without the involvement of an expensive third party.

However, the blockchain is not seen by many as ideally suited for KYC processing, even though its contribution might be crucial to the process of distributing funds and tracking "who owns what". There are many private initiatives researching and developing a way to ease the processing of transactions, payments and entitlements, as well as facilitating client onboarding and KYC challenges.

Bold moves required

KYC was the forerunner of much of the regulation that has since engulfed the financial services industry. It has taken time, but the industry and the technology are catching up with the scale of the challenge set to transform the way these KYC rules are dealt with. Utilities backed with the latest technology could help control costs as new regulations and updates come on stream.

The next few years will see the fourth EU Money Laundering Directive (4MLD), the second Payment Services Directive (PSD2), and General Data Protection Regulation (GDPR). The latter, which comes into force on 25 May 2018, could be particularly relevant to the utility debate. Instead of individual companies spending time developing their own digital identity modules, it suggests that such activity could all be handled centrally.

Investors are demanding lower fees and putting the fund industry sector under greater pressure to deliver value for money. However, this is just when regulations are driving up costs. A bold new approach is needed. A mutualised utility would represent such a shift, with costs being shared and greater accuracy ensured.

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[1] Deloitte Luxembourg – Europe's fund expenses at a crossroads, from https://www2.deloitte.com/lu/en/pages/investment-management/articles/europe-fund-expenses-crossroads.html, last accessed on 19 April 2017. Link here.

> **"The blockchain uses distributed ledger technology (DLT) to track everything from ownership of assets through to identities.**

GLOSSARY

AFR	Annual Funding Requirement
AIFMD	Alternative Investment Fund Managers Directive
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIMA	Alternative Investment Management Association
AML	Anti Money Laundering
APA	Approved Publication Arragement
APER	Statements of Principle and Code of Practice for Approved Persons – FSA High Level Standard
ARM	Approved Reporting Mechanism
ARROW	Advanced Risk-Responsive Operating FrameWork
Basel III	International regulatory framework in the banking sector
BCBS	Basel Committee on Banking Supervision
BIPRU	UK Prudential Sourcebook for Banks, Building Societies and Investment Firms
BRIC	Brazil, Russia, India and China
CBU	UK Conduct Business Unit
CCP	Central Counterparty
CDS	Credit Default Swap
CF	Control Functions
CFT	Counter-financial Terrorism
CIS	Collective Investment Scheme
COBS	Conduct of Business Sourcebook
CRD	Capital Requirements Directive
CRE	Commercial Real Estate
CSSF	Commission de Surveillance du Secteur Financier
DEA	Direct Electronic Access
DFI	Development Finance Institution
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECON	EU Parliament's Economic and Monetary Affairs Committee
EEA	European Economic Area

EEC	European Economic Community
EFAMA	European Fund and Asset Management Association
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EIU	European Intelligence Unit
EMEA	Europe, the Middle East and Africa
EMIR	Emerging Markets Infrastructure Regulation
EP	European Parliament
ESA	European Supervisory Authorities
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchange-traded Fund
EU	European Union
EVCA	European Private Equity and Venture Capital Association
FAIF	Fund of Alternative Investment Fund
FATCA	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FCA	UK Financial Conduct Authority
FCP	Fonds Communs de Placement
FFI	Foreign Financial Institution
FI	Finansinspektionen – Swedish Financial Supervisory Authority
FINMAR	Financial Stability and Market Confidence Sourcebook
FPC	Financial Policy Committee
FSB	Financial Stability Board
FSMA	UK Financial Services and Markets Act 2000
G20	The Group of Twenty Finance Ministers and Central Bank Governors
GDP	Gross Domestic Product
G-SIBs	Global Systemically Important Banks
G-SIIs	Global Systemically Important Insurers
HFT	High Frequency Trading
HIRE	Hiring Incentives to Restore Employment Act
HMT	Her Majesty's Treasury
IA	Investment Association
IAIS	International Association of Insurance Supervisors

IBC	Independent Banking Commission
ICAV	Irish Collective Asset-management Vehicle
ICSD	Investor Compensation Scheme Directive
IFA	Independent Financial Adviser
IFC	International Finance Corporation
IFI	International Finance Institutions
IFIA	Irish Funds Industry Association
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IMS	Investment Management Strategy
IOSCO	International Organisation of Securities Commissions
IRS	Internal Revenue Service
JFSC	Jersey Financial Services Commission
KIID	Key Investor Information Document
LHFI	Lag om Handel med Finansiella Instrument – Swedish Financial Trading Act
LVM	Lag om Vardepappersmarknaden – Swedish Financial Markets Act
MAD	Market Abuse Directive
MEP	Member of the European Parliament
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
NAV	Net Asset Value
Newcits	A phrase used to describe hedge fund strategies used within the UCITS III framework
NBNI G-SIFIs	Non-Bank and Non-Insurer Globally Systemically Important Financial Institutions
NFFE	Non-Financial Foreign Entity
NURS	Non-UCITS Retail Scheme
OECD	Organisation for Economic Co-operation and Development
ORA	Ongoing Regulatory Activity
OTC	Over-the-counter (derivatives)
PBU	UK Prudential Business Unit
PCF	Pre-Approved Control Functions
PIF	Professional Collective Investment Scheme
PFFI	Participating Foreign Financial Entity
PRA	UK Prudential Regulation Authority

PRIIPs	Packaged Retail and Insurance-based Investment Products
PRO	Prudential Risk Outlook
QCF	Qualifications and Credit Framework
QI	Qualifying Intermediary
QIF	Qualifying Investor Fund
QIS	Qualified Investor Scheme
RCRO	Retail Conduct Risk Outlook
RDR	Retail Distribution Review
RIS	Regulatory Information Service
SAR	Special Administration Regime
SEC	Securities and Exchange Commission
SEPA	Single European Payments Area
SICAV	Société d’Investissement à Capital Variable
SICAR	Sociétés d’Investissement en Capital à Risque
SIF	Significant Influence Function
SIF	Specialised Investment Funds
SIFA	Swedish Investment Funds Association
SIFIs	Systemically Important Financial Institutions
SLD	Securities Law Directive
SME	Small and Medium Sized Enterprises
SOPARFI	Sociétés de Participation Financière
SUP	Supervision – FCA Regulatory Process
SYSC	Senior Management Systems and Controls – FCA High Level Standard
TIEA	Tax Information Exchange Agreement
TSC	UK Treasury Select Committee
UCIs	Undertakings for Collective Investment (Part II Funds)
UCIS	Unauthorised Collective Investment Scheme
UCITS	Undertakings for Collective Investment in Transferable Securities
UKTI	UK Trade & Investment
USFI	US Financial Institution
VaR	Value at Risk

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