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INTRODUCTION

Following the publication of our MiFID II special edition last year, it is with renewed pleasure that we welcome you to our first edition of *Global Trustee and Fiduciary Services News & Views* for 2017…

And what better way to start the New Year than with a forward-looking piece that considers the direction asset management regulation might take into 2020 and beyond. Not crystal ball-gazing, this article, written by Guy Sears, previously the interim CEO of the Investment Association, rather offers an enterprising look at asset management derived from Guy's ample experience. Plus there's more…

Our industry insight includes a host of other themes, topics and questions that we believe are of strategic business interest to global asset management participants across the spectrum.

In Asia, we follow the further opening of the Chinese market to foreign investors, most recently with the launch of the Shenzhen–Hong Kong Stock Connect programme in December 2016, which includes an expansion of cross-border regulatory and enforcement cooperation between Hong Kong's Securities and Futures Commission and the China Securities Regulatory Commission to facilitate real-time surveillance of activity in their respective markets.

Moving to the US, we turn to the significant changes that will be of interest to investment management firms registered as investment advisers with the SEC, discussing the amendments to Form ADV, additional information about advisory business and the new Schedule R, and amendments to Schedule D.

Other topics covered in this edition…

Asset management focus…

- What's the Central Bank of Ireland's Strategic Plan for 2016-2018?
- Will there be a bonus cap for Dutch AIFMs and UCITS managers?
- Should enforcement be seperated from the UK's financial regulators?
- What's the latest on a new kind of Corporate Fund in Sweden and on Company Law Reform in Luxembourg?

More broadly, asset managers will also be keen to review our articles on topics that will no doubt be taking priority in their regulatory implementation plans for this year and over the next couple of years, specifically the GDPR, 4AMLD, SM&CR and potentially the UK's Financial Conduct Authority's Asset Management Market Study.

In this edition, we also consider questions or topics arising from the Central Bank of Ireland's strategic plan, bonus caps for Dutch AIFMs and UCITS managers, the separation of enforcement from UK regulators, a new corporate fund in Sweden and Company Reform Law in Luxembourg.

Of course, regulation does not stand still, as demonstrated by Europe's proposals, made on 21 December 2016, for a fifth anti-money laundering directive (due to come into effect at the same time as the fourth) and an associated proposal that aims to counter money laundering by criminal law.

Nor are the findings of national competent authorities mutually exclusive, with BaFIN and Sweden's Finansinspektionen being the latest regulators to raise concerns over active funds with a low active share (i.e. closet trackers), following the FCA's Thematic Review on Meeting investors' expectations – all of which were prompted by ESMA's supervisory work on closet indexing early in 2016. We will continue to monitor developments as they unfold.

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 & Views*, and invite you to contact our Regulatory Services team (see 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.

THE DIRECTION OF ASSET MANAGEMENT REGULATION INTO 2020 AND BEYOND: WHAT MIGHT THE FUTURE HOLD?

This article considers what direction regulation, in particular of asset management and the services around it, might take into 2020 and beyond. While past performance may not be an indicator of future performance in investment, when it comes to regulation, a consideration of the immediate past and present should help identify some of the major trends.

Asset management is a global business, and the firms participating in delivering such services and operating funds do so globally. Global regulation has not always been with us. The last millennium was characterised by an ever-increasing adoption of models of regulation across nations joining IOSCO, often adopting US or more latterly UK/EU templates.[1] At first national policy dynamics were about what should be regulated and how. Now that most nations have introduced comprehensive regulatory regimes, the policy dynamics are now as much if not more at the level of the regulators since they broadly share the same high-level responsibilities, those of consumer protection, prudential strength and financial stability.

This article reflects a realisation about what happens when regulators work with each other more. Some readers will have got this long ago, but it is now widely understood from experience of talking with firms and regulators in the US, Canada and Japan during 2016 that global regulation for firms is no longer merely about what rules one needs to comply with to carry on business outside your home territory: it is also the study of what ideas may be imported to your home territory from outside. The US Department of Labor, Canada's securities regulators and Japan are all exploring local initiatives on duties of care, commission bias and better cost disclosure, whose paradigms can all be traced to the UK's RDR.[2] This is not to say that there is an unquestioning acceptance of an idea from another regulator. But it is a claim that if you want to plan for future regulation in the USA, for example, it is no longer safe to ignore ideas that are emerging in Europe.

So this article speculates on what ideas, what new paradigms of regulation even, might excite the interest of regulators in other countries. Of course, not every country will take the same approach, and some countries will not constitutionally alter the roles of its regulators. But in asking what the next 10 years might bring, this article, which takes an unashamed view from the UK outwards in several examples (not least because of the article's provenance where the UK regime is perhaps better understood), hopes to show how such ideas make sense and, got right, can potentially improve the cost-effectiveness of regulation.

Time for stocktaking

In the years since the Lehman collapse, we have become so engaged with some subjects and organisations that it is hard to believe they are less than eight years old. A few of such topics include:

- Financial Stability Board – financial stability as a non-banking theme
- Financial Conduct Authority (FCA) – having competition powers
- The real economy – distinguishing most other parts of the economy from financial services

Some themes are longer-standing – consumer protection has been at the centre of regulation since the modern era of UK regulation commenced on 28 April 1988, itself hugely influenced by 50 years of US regulation beforehand. So it is with consumers that our forward look begins.

Looking forward – in the interests of consumers

Given banks' role in the economy and in society, people are debating, similarly to Lord Turner's reference to the debate on financial stability, "whether and under what circumstances we can be confident that the impact of [bank and near bank] activities will be beneficial for the real economy and thus for human welfare".[3] More generally, financial services should operate in the interests of consumers, whether directly or through wider welfare benefits. But consumers come in all shapes and sizes. And the FCA's objectives require it to consider as a consumer, not only you and I, but also the biggest asset managers and insurers, when provided with services by banks in the capital markets.

For the FCA, therefore, consumers can include any person who may be affected by the impacts that financial services may have on the real economy. But decades of focus on consumer protection by SROs, the FSA and the FCA, leave many struggling to know if the vast investment in consumer protection was worth it.[4] To an outsider, staggering levels of fines, redresses and complaints appear to continue unabated. In part, the past response to this was to reorganise the regulators, both in the UK and in the EU, and to write more rules. But many of these approaches can't be expected to last into the 2020s. While there are always legitimate cries from politicians and society to stop the repetition of past scandals, lawyers and conduct policy staff now know that writing rules merely directed at some past event is a failed paradigm and deeper, evidence-based approaches need to be employed. In that regard, there are already emerging two new (and linked) trends in consumer protection, both being led or embraced by the FCA, that can be expected to continue.

Regulatory Tool

The **first trend** relates to the tools used by regulators. Simply put: rule-making does not appear to have been effective in preventing misselling, manipulation or market failures. Yet after the fact, the rulebook provides a plethora of penalties that can be imposed on individuals and firms. Two new powers point to new approaches by regulators.

Powers for product intervention will soon be complemented by target market requirements across the EU. And while the UK has had product provider responsibilities guidance for some years, the newer powers can only lead to a greater fear of forecast intervention.[5] In return, that fear will likely incentivise far clearer descriptions of what products, including funds, are designed to do. Arguments that manufacturers purely produce components based on asset classes, while historically legitimate, do sit uneasily with outcome-focused, lifestyle and similarly marketed funds.

But it is the second set of new powers that will provide the greatest refocus of consumer protection – the competition powers that the FCA has been given put it in a very select group among the world's securities regulators, allowing the FCA to analyse much deeper structural issues and propose solutions that can use all its powers, including better rule-making. The final outcome of the asset management market review is only a likely start in this area, as the competition approach will likely inform, and be used in, the 2017 review of the RDR.

The FCA Asset Management Market Study Interim Report

The FCA's long-awaited interim report into the UK's asset management and funds industry was published on the 18 November 2016. While enquiring into institutional and retail (fund) business, it also looks at some of the roles of investment consultants. It does not, however, go into the same depth on distribution and excluded advisers; the RDR review due in 2017 must be a likely starting point for a deeper consideration of advisers and other intermediaries.

The interim report combines two interlocking aspects of the FCA's work. On the one hand, the Report uses econometric analysis and raises issues through a competition lens; on the other, several other parts of the Report gather together policy themes that have been more or less discussed by the fund industry, commentators and consumer groups, if not the FCA, since the financial crisis. So transparency and the signals that investors use to decide what to buy, or sell, are explored.

The FCA finds weak price competition, that actively managed fund charges have not reduced significantly over the last decade, that there are price clusters at 75 and 100 bps and that asset managers enjoy substantial margins.

Turning to the funds themselves the FCA has concerns that objectives are not adequately explained to investors, that some active funds track to the market benchmark to an extent that investors would be better off buying cheaper passive funds and that anyway after costs on average actively managed investments do not outperform their benchmarks.

Though the FCA mentions the difficulties fund managers have in switching investors in older, more expensive legacy classes into clean share classes, it offers little in the way of radical change. In several other areas, however, the FCA is asking whether much more radical change is warranted.

» Firstly, the FCA asks if fund governance needs overhauling. Whether adopting a US mutual fund-style board, adopting a majority independent board or using the depositaries, the FCA is looking for an investors' champion to provide far higher levels of independent assurance about value of money and cost oversight. This could embrace reviews of the fee charged by the investment manager and of the transaction costs incurred in trading in the capital markets.

» Secondly, the FCA asks, echoing the Financial Services Consumer Panel, whether a move to some form of all-in-one fee would be in investors' interests. Variations on this theme would involve the fund manager bearing more or less of the risk of budget overruns and transaction costs.

» Thirdly, the FCA asks in several areas about how better information can be provided to investors and within that, whether signals that identify underperformers could be found.

The FCA is asking for comments by 20 February 2017 and is expected to make final recommendations for change in the second half of 2017. Many will be responding, not only with regards to their UK funds but also with a PRIIPs lens on, on how this will affect the competitive landscape with passported-in EU funds (now and after Brexit) and unit-linked business and investment trusts.

Consumer responsibility

The **second trend** is the desire to grapple with the concept of consumer responsibility. Debate about how much a regulator should intervene – either across a sector through rules or with an individual firm through supervision – has for years been hobbled by the absence of any clear articulation of the nature and limits of consumer responsibility.[6] Andrew Bailey, the FCA CEO, announced in July that there would be a public consultation on whether some consumers should be prioritised over others and the wider balancing exercise of firm, consumer and regulator responsibilities.[7] The paper is now out and all interested groups can now debate the best way forward.[8]

Importantly, this debate will occur after two key groups have altered their approaches to the issue. The first are consumers themselves, together with the political class. The 2008 financial crisis can be understood to have reversed the burden of proof on financial services and related themes. Beforehand, despite being a licenced activity, there was a broad assumption that financial services, more liquidity and universal banks each brought benefits. Now it is understood that there are boundary conditions to each of these assumptions, viz they are true up to a point. Since the financial crisis, society expects the financial services industry to demonstrate that what it proposes will not cross that line.

Equally important, when considering its approach to consumer responsibility, the FCA is changing its mindset. It is embracing behavioural economics. Rather than presume consumers have unlimited capacity to learn and choose, regulators have noticed that "a rapidly growing literature on behavioural economics shows that some errors made by consumers are persistent and predictable."[9] Taken together, we can expect a regulator to spend much more time understanding what responsibility means in light of real-world biases and to adjust rules accordingly. There will be no bonfire of rules, but there will be pruning and replacing.

Brexit needn't be expected to cause any significant alteration of consumer protection. Indeed in the EU, the UK has been either a source or a supporter of many EU consumer-focused initiatives. But the UK will be freer to follow these trends to a different and potentially faster timetable than the EU. Even if equivalence with the EU is a key constraint on future UK regulatory initiatives – and how much the UK is willing to so limit itself is still a very open issue – it is likely that all these approaches, such as following a mission based on an articulated position on consumer responsibility, using product intervention, carrying out further market reviews using competition and then implementing corrective rules after – will pass an equivalence test. However, the associated concern related to any passing of such test will be the safeguards attached to its granting and how easily they can be withdrawn.

These trends are part of a bigger question, however, that the UK government at or after Brexit must address. What is the right level of paternalism in relation to financial services?[10] Again, this question will be asked in a new sociopolitical context. The first decade of UK regulation could be said to have been focused on investors, with all the higher-net-worth, discretionary-spend impressions that such terms can give. Some in the industry understandably still prefer terms like "clients" and "investors" but these terms do not sit so well with a new cohort of individuals whose interests and long-term security in particular UK governments of every political persuasion will seek to promote: those saving for retirement and later life. Around 8 million people already save into a private pension and contributions are around GBP20 billion a year.[11] The numbers will increase significantly. This political refocus from considering people as investors to considering them as individuals saving for retirement through investing will challenge how regulation draws a distinction between products and services and the boundaries of advice.

For example, with increasing life expectancy and changing work patterns, it must be likely that individuals will want to be able to not only accumulate, obtain an income and re-invest that (as now), but also at times consume some of the capital to cover gaps in income and meet unpredictable expenses (such as for health) and then to re-accumulate through new work.

The direction of regulation will depend on the extent to which society and politicians can be confident that financial services activities are indeed beneficial for the real economy and so for human welfare.

Previously, much of the advice and assistance in this area expected a discrete period of accumulation through investing and a discrete period of decumulation through an annuity. This system where, for many, advice basically ends as the phase of accumulation ends, is not fit for the new order. This new complex of cycles of accumulation and expenditure will require advice and assistance as to what capital to spend – between a series of funds – to meet income shortfalls and where to top up. More likely, it will demand default-like products that are wrapped in what are effectively services so as to be done efficiently and in a manner that sufficiently protects this new model's "invested saver", who spends little time considering such issues.

Additionally, at some point downside risk will be addressed by some products. The ending of compulsory annuitisation has left a gap on downside risk. Survey after survey of consumers show they do not want to carry any significant downside risk (unsurprisingly). Part of the services wrapped around a fund may include insurance, a phased-in annuity component or risk immunisation using derivatives. Regulation will need to ensure it keeps pace and this, more than Brexit, will refocus the FCA. The Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS) will need to be stress-tested to ensure they are rightly configured to address the next 10 or 20 years of post-pension freedoms.

Across the Atlantic, just as the Department of Labor has attempted in the US, so we shall need to look at regulation from the invested saver's viewpoint, ensuring regulation does not distort competition while ensuring total cost of ownership, information, tools and options are equivalently approached across all competing products. In that regard, the Financial Advice Market Review (FAMR) has proposed changes to what constitutes regulated advice. But it has recognised as necessary that "the FCA also considers whether it needs any additional powers to address the potential risks from unregulated firms operating in this space".[12] Powers of a regulator over the unregulated sounds like regulation, and it is logical to expect to conclude in due course that the regulated activity of advice speaks to the age when investors were the subject of regulatory thought and that to protect invested savers using multilayered serviced products, regulation should be looking at "advice or assisted guidance in relation to an individuals' later-life provision".[13]

The bilateral distinction between regulated and unregulated will need to reduce and ensure a much more blended approach is taken to guidance and online assistance that is neither advice nor something that should be left unregulated. Even in countries where the state remains responsible for later-life provision, the advance of technologies will rapidly challenge the current hard-edge to regulation of advice that effectively starts from a consideration of the position and experience of firms and not of those of consumers.

Away from immediate consumer protection, and even as the age of asset management dawns, and society relies evermore on individuals to save for their own retirement provision, fears over financial stability remain. The UK will continue to play a significant part in global bodies such as the FSB and IOSCO on this subject. This will be particularly important as the discussions on stress-testing funds ramps up. In the EU or not, the influence of the UK will, as ever, come down to individuals and the extent to which Mark Carney or Andrew Bailey play key roles in committees.

Global engagement

Bilateral engagement among regulators globally is already high, and shared experiences of auto-enrolment and RDR will likely ensure continued engagement with Australian and Canadian colleagues. For the funds industry, international questions may presently be dominated by Brexit. Assuming single market access is no longer unlimited, managers will need to understand what the ramifications are for all the other activities, such as solicitation, marketing and aftersales care. But after that come the bigger global questions. Will the UK outside the EU now allow Chinese and other funds the mutual recognition they seek? Mutual recognition is now a card that the UK government can play, but so can the EU. There, however, the experience of the AIFMD may be telling. Perceived hostility to third country funds is unlikely to turn to a full embrace in the EU unless there is a huge political gain at stake. China, India and Indonesia may offer that, but the UK is likely to start from a more open mindset to the concept of third country firms and funds passporting in.[14]

In 2008, as the financial crisis spread and Lehman collapsed, people, including lobbyists, politicians, legislators, began using a new phrase to express what financial services did and why it was important. It was the term, "real economy". Debate can be had as to what is in or out, but its use, indeed its widespread adoption as a lens through which to consider what the financial services industry is doing, institutionalises an "us and them" approach to regulation and wider financial stability policy. This division remains a huge risk for asset managers, perhaps as much as for any other part of financial services, as it suggests these allocators of capital to businesses and suppliers of later-life income are somehow separate from the world of invested savers (or saving investors), and are not a component of the real economy. More than Brexit, more than the level of an index, more than inflation figures, the direction of regulation will depend on the extent to which society and politicians can be confident that financial services activities are indeed beneficial for the real economy and so for human welfare.

Guy Sears

[1] International Organisation of Securities Commissions.

[2] Retail Distribution Review (RDR).

[3] "What Do Banks Do, What Should They Do and What Public Policies are Needed to Ensure Best Results for the Real Economy?", speech by Lord Aidar Turner at Cass Business School, 17 March 2010.

[4] SROs are Self-Regulatory Organisations that, along with the Securities and Investments Board, enforced UK regulation until 2001, when they were replaced by the Financial Services Authority (FSA). The FSA was replaced by the FCA from 1 April 2013.

[5] From https://www.handbook.fca.org.uk/handbook/document/rppd/RPPD_Full_20160321.pdf, last downloaded on 30 November 2016.

[6] The fourth principle of good regulation imposed on the FCA is entitled "Consumer responsibility" and it states "Consumers should take responsibility for their decisions." History has shown this is broadly uninformative.

[7] Speech by Andrew Bailey at the FCA's 2016 annual public meeting, accessible at https://www.fca.org.uk/news/speeches/chief-executive-speaks-apm-about-recent-work-and-future-challenges, last accessed on 30 November 2016.

[8] See https://www.fca.org.uk/publications/corporate-documents/our-future-mission, last accessed on 30 November 2016.

[9] From https://www.fca.org.uk/publication/occasional-papers/occasional-paper-1.pdf, last downloaded on 30 November 2016.

[10] Despite not being gender neutral, the term seemed apposite.

[11] From https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/556011/September_2016_Pensions_publication.pdf, last downloaded on 30 November 2016.

[12] See page 32 of FAMR's final report, available at https://www.fca.org.uk/publication/corporate/famr-final-report.pdf, last downloaded on 30 November 2016.

[13] Arguably this is similar to what has motivated the US Department of Labour, available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest, last accessed on 30 November 2016.

[14] China, India and Indonesia are only three examples among others, but these are particularly populous nations.

UPDATE: CHINA MARKET ACCESS

Taking a high-level overview of the various ways in which foreign investors can access China's equity and bond markets, this article focuses on some of the more recent and relevant updates to and thinking on the QFII, RQFII, SZ-HK Stock Connect and CIBM regimes in particular, each of which has its own advantages and disadvantages for the discerning fund manager.[1]

Introduction

There are many things that investors can say about investing in China, but "uneventful" is not one of them. At the beginning of 2016, the Shanghai Composite Index was down over 40% since its height during the summer of 2015. This volatility is not unusual in the Chinese market, but with the imposition of a circuit breaker (which lasted about one week) and the vast number of stocks listed on the Chinese markets that suspended their listing, it certainly made for a hectic start to the year.

The access channels for foreign investors looking to invest in Chinese equities and bonds are numerous and constantly evolving. In a relatively short period of time, for example, we have seen the launch of Shanghai-Hong Kong Stock Connect, the launch of Mutual Recognition of Funds (MRF) scheme, the relaxation of the rules for the Qualified Foreign Institutional Investor (QFII) Scheme and the Renminbi Qualified Foreign Institutional Investor (RQFII) Scheme, and the widening of access to the Chinese Interbank Bond Market (CIBM), while the list of countries granted RQFII quota has increased along with the launch, most recently, of the Shenzhen-Hong Kong Stock Connect (SZ-HK Stock Connect).

This activity has not taken place in a vacuum. It is driven by the desire of the Chinese authorities to attract international investors to their markets generally and to be included in MSCI indices, which, at a stroke, will cause billions of dollars to be invested into Chinese stocks, as anyone tracking these indices will be required to invest into the A share market.[2] It is therefore worth getting to grips with these regimes at an early stage – to the extent that asset managers operate index-tracking funds that would be affected by the inclusion of China A shares in any MSCI index in 2017, there will undoubtedly be various regulatory hoops to jump through both in the UK and abroad.[3]

Below we focus on the recent developments to the QFII, RQFII, SZ-HK Stock Connect, and CIBM opportunities in particular.

QFII

Background

QFII is the longest running of the access programmes. It was launched in 2002 to enable specified types of institutional foreign investors to invest in Chinese equities. As of October 2016, 273 foreign institutions were approved as QFIIs, holding an aggregate QFII investment quota of USD84.438billion.[4]

The scheme has been subject to substantial change over the years with the two most recent reforms occurring in 2012 and 2016.[5] All of the reforms have made it progressively easier for foreign investors to access Chinese equities. The relaxations will be of note to institutions interested in taking advantage of the opportunity of participating in Chinese stock markets, and they also help to address the concerns of retail investment managers in the UK and elsewhere as to how to access the market while satisfying investor protection and risk management requirements at home.

Products and participants

QFIIs and their products are broadly classified into three types, for State Administration for Foreign Exchange (SAFE) regulation and for FX purposes, namely:[6]

- Long-term investors, such as pension funds, insurance funds, charitable foundations, endowment funds, government and monetary authorities (Long-Term Funds).
- Open-end China funds (essentially a type of fund product managed by a QFII), which are defined as open-end securities investment funds set up offshore by QFIIs via public placements, where at least 70% of assets are invested in the securities market in China (Open-end China Funds).

Applicant	Operating history	Net assets	Assets held or managed (during preceding accounting year)	Other requirements
Asset management institutions	2+ years	N/A	At least USD500 million	N/A
Insurance companies	2+ years	N/A	At least USD500 million	N/A
Securities companies	5+ years	At least USD500 million	At least USD5 billion	N/A
Commercial banks	10+ years	N/A	At least USD5 billion	Tier-one capital of at least USD300 million
Trust companies	2+ years	N/A	At least USD500 million	N/A
Other institutional investors	2+ years	N/A	At least USD500 million	N/A

- Mandates managed by a QFII, QFIIs' proprietary money if the QFII does not qualify as a Long-Term Fund, funds managed by a QFII that do not qualify as Open-end China Funds, etc. (Other Funds).

Process and accessing the QFII regime

To qualify as a QFII, applicants must meet the threshold conditions and tests summarised below (see too table above):

- Applicants must satisfy various financial thresholds (table).
- The investment team of the QFII must meet the necessary professional standards prevalent in its home country.
- The QFII must have appropriate internal systems, controls and corporate governance.
- The QFII must have at least three years' clear regulatory record with no material penalties imposed.
- The QFII must be established in a jurisdiction with a well established legal and regulatory regime that has entered into a memorandum of understanding with the CSRC and has a good relationship with the CSRC.

In general, it would be expected that most large retail asset managers and pension funds in the UK should be capable of meeting these conditions.

Investment restrictions and requirements

As with most methods of accessing the Chinese markets, the QFII regime includes several restrictions on investing in the market and repatriation of capital.

Investment quotas

Previously, QFIIs were required to obtain prior approval from SAFE for each investment quota. The 2016 rule changes have now relaxed this requirement. Participants have only a simple filing obligation with SAFE if the investment quota is within a certain percentage of the asset value or AUM of the QFII – what is known as the "base investment quota". It should be noted that the base investment quota will not apply to certain QFIIs such as sovereign wealth funds, central banks, long-term investors or monetary authorities. Participants wishing to increase their quota – within the parameters of the base investment quota – may also do this by way of filing. Increases that will take a QFII outside the base investment quota still require prior SAFE approval.

Mandatory investment

Previously, under SAFE regulations, QFIIs were required to invest the full amount of the investment quota granted to them within six months of receiving SAFE approval. This has been relaxed somewhat, and QFIIs have up to a year to invest their quota, any balance remaining being liable to be revoked by the SAFE at its discretion.

Lock-in periods

All QFIIs are now subject to a mandatory three-month lock-in period, during which no invested funds may be withdrawn. The lock-in period now starts to run once an aggregate USD20 million has been paid into the QFII's account with the onshore custodian, rather than once the full amount of the quota has been remitted as was previously the case, which will shorten the lock-in period in practice. Following the expiry of the lock-in period, there are restrictions and quotas for withdrawing and repatriating assets.

Daily repatriation of funds is permitted provided that monthly aggregate repatriation does not exceed 20% total onshore commitment as at the end of the previous year. Repatriation of principal is permitted only on application to SAFE (except in the case of Open-end China Funds, which do not need to seek approval). This and the other capital-mobility restrictions applicable to the QFII Scheme generally has been a long-standing cause for concern for many investors, and MSCI has indicated that concerns surrounding lock-in must be appropriately resolved before China A shares can be included in any MSCI indices. At the moment, it looks as though nothing short of a complete revocation of the 20% monthly repatriation limit will satisfy MSCI.

Investment restriction

Various restrictions applicable to holdings in China A shares will, by extension, also apply to QFII holdings of China A shares. In brief, these restrictions comprise:

- A single QFII may not hold more than 10% of the total outstanding shares in a single company issuing China A shares.
- The aggregate foreign shareholdings in a company issuing China A shares must not exceed 30% of total outstanding shares.

The 2016 changes to the QFII scheme may assist US and UK managers in getting comfortable with accessing China's market. With the 2016 updates to the scheme, China appears to be demonstrating a commitment to addressing at least some of the issues that have so far limited the appeal of the QFII scheme to Western retail funds. The potential future appetite to apply for a QFII and RQFII quota in the context of the developments of the stock connect schemes is the subject of much debate. While we could debate this topic for some time, it really is a matter of watching this space at this point.

RQFII

RQFII is substantially similar to the QFII regime but focuses on making it easier to invest renminbi held outside China in Chinese securities. The principal difference between the QFII and RQFII regimes is that under the RQFII regime, funds are remitted into China in RMB, rather than in any foreign currencies, although funds can be repatriated in any freely exchangeable foreign currency. Recent amendments made in September 2016 were designed to reconcile with the QFII rules and promote alignment between the schemes.

Financial institutions in 17 countries have now been granted RQFII quotas including the UK, France, Singapore, Canada and Australia. The US was granted a quota this summer, but at the time of writing, we understand no US houses have taken up this opportunity as yet. The total quota allocation is now RMB514.988 billion. So far 10 countries have used part of their quotas, the greatest take-up by far from institutions in Hong Kong, South Korea and Singapore, with the UK taking fourth place.[7]

Background and eligibility

Applicants for an RQFII licence must:

- Have a relevant asset management licence.
- Be in a stable financial condition and have a good credit standing.
- Have an effective corporate governance and internal control system, and its relevant professionals must satisfy eligibility requirements applicable under local law.
- Not have had any material penalty imposed by the relevant local regulator since its establishment (if it has a track record period of less than three years) or in the last three years.
- And satisfy such other requirements of CSRC as it may stipulate in accordance with the principle of prudential regulation.

The 2016 changes did not affect these requirements.

Investment quotas

As for the QFII regime, the position previous to the 2016 rule updates was that prior approval from SAFE for the relevant quota was required before any investment in the PRC could be made.[8] A similar relaxation has now been applied to RQFII, as set out above.

Mandatory investment and lock-in periods

Unlike the position for QFIIs, open-ended funds managed by RQFIIs may remit and repatriate capital without restriction. That said, the expectation is that the investment quota for

Each of the access programmes referred to in this article come with their advantages and disadvantages…What is unquestionable now is that China truly is a global powerhouse.

open-ended funds is "effectively utilised" within one year after being granted by SAFE.

For most other RQFIIs, not only must the investment principal be remitted to the PRC within six months from the date the relevant quota is granted, but there is also a lock-in period of three months, starting from the date on which an aggregate amount of no less than RMB100 million has been remitted to China within the RQFII's quota. Following the expiry of the lock-in period, both the principal invested and any other funds may be repatriated. However, RQFIIs should be aware of the consequences of repatriating principal. The RQFII quota is reduced according to how much of the principal is repatriated and, once taken back offshore, cannot be reinvested onshore in excess of the reduced quota. The 2016 changes removed the restriction on daily liquidity, and there is now no requirement to repatriate funds solely on a monthly basis.

Stock Connect

Following the successful development of Shanghai-Hong Kong Stock Connect, the "Shenzhen-Hong Kong Stock Connect" programme launched in December (see the table below for some of its key features).

The stocks traded on the Shenzhen exchange are frequently issued by Chinese companies operating in the burgeoning tech, pharmaceutical and energy sectors. We expect that SZ-HK Stock Connect will provide another important conduit for international investors seeking access to China's market in these areas.

Quotas

SZ-HK Stock Connect has no aggregate quota and, interestingly, the previous aggregate quota under Shanghai-Hong Kong Stock Connect is now also abolished. The two stock-connect programmes will have the same daily quota (RMB13 billion for Northbound trading and RMB10.5 billion for Southbound trading).

Trade directions

SZ-HK Stock Connect enables trading in two directions (see too table below):

- Northbound allows investors outside China to trade eligible equities on SZSE, routed through Hong Kong brokers and a securities-

Key features of SZ-HK Stock Connect

	Northbound	Southbound
Eligible shares	Any constituent stock of the SZSE Component Index and SZSE Small/Mid Cap Innovation Index that has a market capitalisation of RMB6 billion or above and all Shenzhen Stock Exchange (SZSE) – listed shares of companies that have issued both A shares and H shares.	The constituent stocks of the Hang Seng Composite LargeCap Index and Hang Seng Composite MidCap Index, any constituent stock of the Hang Seng Composite SmallCap Index that has a market capitalisation of HKD5 billion or above, and all Stock Exchange of Hong Kong-listed (SEHK-listed) shares of companies that have issued both A shares and H shares.
Investors	(Initial stage) investors eligible to trade shares listed on the ChiNext Board of SZSE under the Northbound Shenzhen Trading Link will be limited to institutional professional investors.	(Initial stage) institutional investors and individual investors who hold an aggregate balance of not less than RMB500,000 in securities and cash accounts.
Brokers	SEHK members who fulfil eligibility requirements.	SZSE members who fulfil eligibility requirements.
Currency	Traded and settled in offshore RMB.	Traded in HKD and settled in RMB.
Trading venue	SZSE.	SEHK.
Clearing house	ChinaClear.	Hong Kong Securities Clearing Co.

trading service company to be established by SEHK in Shenzhen.

- Southbound allows investors in China to trade selected equities on the SEHK, through their appointed mainland securities firms and a securities-trading service company established by SZSE in Hong Kong.

Limitations and issues

SZ-HK Stock Connect is likely to have similar limitations to those applicable to the Shanghai-Hong Kong Stock Connect programme. Based on Shanghai-Hong Kong Stock Connect, these are likely to include the following.

- Day trading is not permitted.
- No off-exchange trading is permitted. SZSE stipulates that investors can only sell shares that are already held in trading accounts the previous day (i.e. T-1). This could create a barrier to global investment managers as it restricts their ability to react quickly to changing market conditions. The work-around permitted in Shanghai-Hong Kong Stock Connect enabling participants to open "special segregated accounts" should enable the buy side to meet the pre-trade checks without pre-delivery of shares.
- It is expected that SZ-HK Stock Connect will not fully support delivery versus payment although recent improvements to the Shanghai-Hong Kong Stock Connect programme have reduced broker risk considerably.
- Trading is likely to be done through a new, dedicated SZ-HK Stock Connect gateway.
- A shares acquired through SZ-HK Stock Connect are not fungible with A shares acquired through the QFII or RQFII schemes.
- The questions over the extent of beneficial ownership of shares held by Hong Kong Securities Clearing Company (HKSCC) remain. Notably, investors are not the named owners of shares held by HKSCC as nominee. However, most investors are now satisfied with the position established by the publication of several Q&A documents confirming that China recognises the features of the nominee structure. There had been concerns about how investors could enforce their rights where they were not the registered holders. China has confirmed that the nominee arrangements should work in a way familiar to Western investors, and that HKSCC will effectively act as a conduit for both distributing dividends to the ultimate shareholder and collecting and effecting voting instructions from ultimate holders.[9]
- It is likely that the same concerns over suspension of stock trading that have applied to Shanghai-Hong Kong Stock Connect will also apply to SZ-HK Stock Connect. MSCI has commented that one of the primary issues it wishes to see addressed is a significant reduction of the number of suspended stocks on the Shanghai and Shenzhen exchanges. Recently, China has clarified trading suspension policies in respect of both exchanges – it remains to be seen how effective the new policies are in practice. The Shanghai Stock Exchange has published Q&A documents discussing their new guidelines.[10] The point of greatest interest will be the introduction of new controls as to the length of time stocks can be suspended in various circumstances. The guidelines now indicate that maximum suspension time should not exceed between 10 days to 5 months, depending on the trigger for the suspension, which is an improvement to the previous position.

CIBM

China has been endeavouring for some years to open up the CIBM to a greater array of foreign investors.

In 2015 and, subsequently, in the spring of 2016, China announced various changes to the rules applicable to CIBM, which have been heralded as finally enabling meaningful foreign investment in CIBM.[11] A wide range of foreign institutional investors will now be able to access the CIBM without the requirement to undergo a lengthy approval or licensing process. Again, it seems safe to assume that China has taken on board concern reported by MSCI and the industry in general as to the administrative burden of pre-approval requirements for activities generally in Chinese markets.

Eligible investors

The only kind of investor eligible to participate in CIBM without prior approval are financial institutions and other institutional investors, including, among others, foreign banks, insurers, fund managers, QFIIs and RQFIIs (subject to FX rules) and certain medium- and long-term institutional investors such as pension funds recognised by the PBOC.[12] When the rules setting out eligible investors were announced earlier this year, they were hailed in some quarters as a milestone in the opening of access to the

Chinese markets generally, and we expect that industry participants and commentators will be watching CIBM activity closely to see whether further relaxations – in CIBM and the other access schemes – might be on the horizon.

These investors will be able to trade bonds on CIBM and effect certain hedging transactions such as bond forwards and interest-rate swaps.

Interestingly, participants must appoint a local settlement agent prior to commencing trading. Much of the local compliance burden will settle on such local agent rather than the investor itself.

Questions and issues

As with the other programmes and opportunities for investment in China touched on in this article, there remain a significant number of questions and issues surrounding investment in CIBM that offshore financial institutions grapple with. Examples include the following points.

- How are potential participants who do not fall within the entities expressly listed in the rules to classify themselves as PBOC-recognised "medium- or long-term institutional investors"?
- Where offshore investors enter into derivative contracts with specific local clearing requirements, will these requirements apply to the offshore investor, and, if so, how should these be navigated and complied with in the context of requirements that might also apply in the investor's home jurisdiction?
- For QFII and RQFII participant investors, how will the rules applicable to those regimes work alongside the CIBM requirements?

Final remarks

Each of the access programmes referred to in this article come with their advantages and disadvantages and will appeal to different types of managers for different reasons. What is unquestionable now is that China truly is a global powerhouse. Its debt and equity markets are enormous and present potentially great opportunities for asset managers to give their clients access to deep and liquid markets and companies that in many cases are developing into global market leaders.

While this is not to say that investing in Chinese debt and equity markets is without its challenges, the size of the opportunity certainly warrants a close and detailed review. For those that prepare properly and understand the challenges, risks, and opportunities, there is the potential to offer exposure to very interesting investment opportunities.

If the Chinese authorities continue to work towards liberalising access to China A shares, the inclusion of those shares in MSCI indices will require asset managers to address how they take exposure to China A shares.

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[1] In this article "China" means mainland China and excludes Hong Kong, Macau and Taiwan.

[2] Find out more about MSCI at www.msci.com/indexes. For useful background on China A shares, see "Consultation on China A-Shares Index Inclusion Roadmap", published by MSCI in June 2016.

[3] China A shares means shares denominated in Renminbi that are traded on the Shanghai and Shenzhen stock exchanges.

[4] See http://www.safe.gov.cn/wps/portal/sy/glxx_jwjgmd, last accessed on 23 November 2016.

[5] See the Foreign Exchange Administrative Rules on the Domestic Securities Investment by Qualified Foreign Institutional Investors (Revised Rules), which took effect on 3 February 2016.

[6] SAFE refers to the Chinese State Administration of Foreign Exchange. The main regulations governing the QFII scheme are the revised "Administrative Measures on Domestic Securities Investment by Qualified Foreign Institutional Investors" issued by the CSRC, the PBOC and the SAFE in 2006, the Provisions on the Foreign Exchange Administration of Domestic Securities Investments by Qualified Foreign Institutional Investors issued by the SAFE on 29 September 2009, the "Provisions on Relevant Matters concerning the Implementation of Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors issued by the CSRC in July 2012, and the "Provisions on Foreign-Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors" issued by the SAFE in December 2012, and the Foreign Exchange Administrative Rules on the Domestic Securities Investment by Qualified Foreign Institutional Investors (Revised Rules) which took effect on 3 February 2016.

[7] Sew http://www.safe.gov.cn/wps/portal/sy/glxx_jwjgmd, last accessed on 23 November 2016.

[8] PRC is People's Republic of China.

[9] For further information see the FAQ on beneficial ownership published by the China Securities Regulatory Commission at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/PressConference/201505/t20150515_277108.html, last accessed on 10 November 2016.

[10] See http://english.sse.com.cn/aboutsse/news/newsrelease/c/4121069.shtml, last accessed on 10 November 2016.

[11] Announcement on Matters concerning Permitting the Access of Foreign Central Banks and Similar Institutions to China's Inter-Bank Foreign Exchange Market (PBOC Announcement [2015] No. 31 Announcement) and Announcement on Relevant Matters concerning Further Improvement in the Investment in the Interbank Bond Market by Foreign Institutional Investors (PBOC Announcement [2016] No. 3 Announcement).

[12] POBC is People's Bank of China.

RECENT REGULATORY CHANGES AFFECTING INVESTMENT ADVISERS REGISTERED WITH THE SEC

The U.S. Securities and Exchange Commission (SEC) has recently adopted changes and proposed additional changes that will have an impact on all investment management firms registered as investment advisers with the SEC. Here we take a look at what some of these changes entail.

The SEC amends Form ADV

The SEC has adopted amendments to Form ADV, used to register investment advisers under the Investment Advisers Act of 1940 (Advisers Act) (Final Rule).[1] The Final Rule became effective on 31 October 2016, with a compliance date of 1 October 2017.

As a result of the Final Rule, advisers registering on Form ADV will be required to report extensive additional information – with a focus on separately managed accounts (SMAs) – which will be made available to the general public. In addition, multiple private fund advisers operating as a single advisory business will be able to register using a single Form ADV. The Final Rule is designed to fill what the SEC believes are certain data gaps regarding SMAs and assist the SEC in carrying out its risk-based examination programme and further other monitoring activities.

Amendments to Form ADV

Disclosures regarding SMAs

The Final Rule requires advisers to annually report the percentage of SMA regulatory assets under management (RAUM) invested in each of 12 broad asset categories.[2] Advisers may use their own consistently applied internal methodologies and the conventions of their service providers to determine how to categorise assets.

Regarding derivatives and borrowings, the Final Rule requires advisers with at least USD500 million, but less than USD10 billion, in RAUM attributable to SMAs to provide certain information as part of filing their annual updating amendment to Form ADV. Specifically, advisers must provide the following information:

- Advisers with more than USD500 million. The Final Rule requires advisers to report the amount of RAUM in SMAs, and dollar amount of borrowings attributable to those assets, based on three categories of gross notional exposure: less than 10%, 10-149%, and 150% or more.
- Advisers with at least USD10 billion. In addition to the reporting described above, the Final Rule requires these advisers to report (based on RAUM in SMAs) the derivatives exposure in each of six categories of derivatives.[3] Information regarding borrowings must be reported based on the total dollar amount of borrowings that corresponds to the different ranges of gross notional exposure.

The Final Rule also requires that advisers identify any custodians that account for at least 10% of SMA RAUM and the amount held at each custodian.

Additional identifying disclosures

Social media sites

The Final Rule requires disclosure of any social media accounts used by the adviser where the adviser controls the content, including the addresses of the adviser's social media pages. While there is no definition of "social media platforms," the Amended Form ADV and Schedule D should include platforms such as Twitter, Facebook and LinkedIn.

Office location and activity disclosure

The Final Rule requires that advisers report the total number of offices where they offer investment advisory services and the 25 largest offices (by number of employees). Advisers are required to report for each such office the number of employees serving in an advisory capacity, the business activities that take place and any other investment activities conducted.

Chief compliance officer outsourcing

Currently, advisers are required to provide the name and contact information of the adviser's CCO. The Final Rule now also requires an adviser to report whether or not its CCO is compensated or employed by any person other than the adviser (or a related person of the adviser) for providing chief compliance officer services to the adviser. If applicable, the adviser would be required to disclose the name and IRS Employer Identification Number (if any) of that service provider. However, advisers are not required to disclose the identity of a related person of the adviser or the identity of another person compensating or employing the CCO, if such other person is an investment company registered under the Investment Company Act of 1940 and is advised by the adviser.

Additional information about advisory business

The Final Rule amends Form ADV to require more specific information about the amount and proportion of an adviser's RAUM by client type. As a result of the Final Rule, advisers are required to report the number (rather than percentage) of clients and the amount (rather than percentage) of RAUM attributable to each category of client. Notably, advisers with fewer than five clients in a particular category need not disclose the actual number of clients, and can instead check a box indicating that they service fewer than five of a particular client type.

Currently, an adviser must disclose the number (in the form of a range) of clients to whom the adviser provided advisory services during the most recent fiscal year. Instead, the Final Rule requires advisers to disclose the number of clients the adviser provided advisory services to, *but for whom the adviser did not manage regulatory assets*, such as non-discretionary accounts or one-time financial plans.

An adviser is also required to report the percentage of its clients that are non-US persons. Under this reporting regime, an adviser could report a high percentage of clients that are non-US persons even though the RAUM attributable to those clients makes up only a small percentage of the adviser's overall RAUM. To better understand the adviser's relationship with non-US clients, the Final Rule requires reporting the approximate amount of an adviser's total RAUM attributable to clients that are non-US persons. As a result, a foreign adviser registering with the SEC, but with a principal place of business outside the US, would be required to report information pertaining to the non-US portion of its business.

The Final Rule requires an adviser to report RAUM of all "parallel managed accounts" related to a registered investment company (or series thereof) or business development company advised by the adviser.[4] The SEC noted that this information would assist the SEC staff in addressing how an adviser manages conflicts of interest, and also show the extent of any shift in assets between parallel managed accounts and registered investment companies or business development companies.

Umbrella registration

Background

When the private adviser exemption was repealed by the Dodd-Frank Act, advisers to private funds were required to register under the Advisers Act.[5] Tax, legal and regulatory considerations led many private fund advisers to organise and operate a group of special purpose entities (SPEs) that are separate legal entities, in order to manage the advisers' sponsored private funds. Even though these groups of related advisers generally operate as a single advisory business, because each SPE could be deemed to be acting as an investment adviser, the sponsor often registers them as separate investment advisers. In 2012, the SEC staff provided relief in the form of a no-action letter to the American Bar Association (ABA) allowing a private fund adviser to file a single Form ADV (umbrella registration) on behalf of itself and other advisers that were controlled by or under common control with that filing adviser.[6] However, Form ADV was designed to accommodate registration by a single legal entity. As a result, the registration of multiple legal entities operating a single advisory business on a single Form ADV led to confusing and inconsistent disclosures. Through a series of Form ADV amendments, the SEC has addressed these issues.

Notably, the Final Rule lists several conditions that must be satisfied in order for a group of related advisers to take advantage of the umbrella registration provisions.

Qualifying for umbrella registration

An adviser (filing adviser) is required to file Parts 1 and 2 of a single Form ADV that includes all required information about itself and each other adviser (relying advisers), to use an umbrella registration to satisfy the requirements of Form ADV. While commenters suggested expanding umbrella registration to apply to other types of advisers besides private fund advisers, the SEC did not do so.[7]

The Final Rule adopts the same conditions as in the ABA Letter, permitting umbrella registration if a group of related advisers is operating a single advisory business where each of the relying advisers is controlled by or under common control with the filing adviser (together, all advisers), and in accordance with the following:

- All advisers advise only private funds and SMAs for qualified clients who are eligible to invest in those private funds, and whose accounts pursue substantially similar investment objectives and strategies as those private funds.
- The principal office and place of business of the filing adviser is in the US.
- Each relying adviser, its employees and those acting on the relying adviser's behalf are "persons associated with" the filing adviser, and thus under the supervision and control of the filing adviser.
- The relying advisers' advisory activities are governed by the Advisers Act and relying advisers are subject to examination by the SEC.
- And all advisers operate under a single code of ethics, single set of written policies and procedures, and have the same CCO.

New Schedule R and amendments to Schedule D

To clarify and provide additional disclosure, the Final Rule requires completion of a new Schedule R for each relying adviser with respect to certain identifying information, including organisational form, ownership and control persons.

Effective and compliance date

The Final Rule became effective on 31 October 2016. The compliance date for Form ADV amendments is 1 October 2017.

The SEC's business continuity plan requirements for advisers

On 28 June 2016, the SEC proposed a new rule (Proposed Rule 206(4)-4 under the Advisers Act) that would require every SEC-registered investment adviser to adopt, implement and annually review a written business continuity and transition plan with certain enumerated components, reasonably designed to address the risks of a significant disruption in the adviser's operations.[8] The Proposing Release does not include a proposed compliance date or timeframe.

Proposing Release

Regulatory background

The Proposing Release notes that, although the SEC previously addressed business continuity planning when it required advisers to adopt compliance programmes pursuant to Rule 206(4)-7 under the Advisers Act, the staff of the SEC has observed a range of practices with respect to the robustness of advisers' operational risk management practices and business continuity plans. In particular, the Proposing Release states that the "staff has noted weaknesses in some adviser [business continuity plans] with respect to consideration of widespread disruptions, alternate locations, vendor relationships, telecommunications and technology, communications plans, and review and testing." Furthermore, the Proposing Release highlights the importance of business continuity planning for the resiliency of the US financial system.

In the Proposing Release, the SEC states that, because advisers owe fiduciary duties of care and loyalty to their clients, an adviser must seek to protect client interests from being placed at risk as a result of the adviser's inability to provide advisory services.

Further, Section 206(4) of the Advisers Act authorises the SEC to adopt rules designed to prevent fraudulent and deceptive conduct, and the Proposing Release indicates that the SEC "believe[s] it would be fraudulent and deceptive for an adviser to hold itself out as providing advisory services unless it has taken steps to protect clients' interests from being placed at risk as a result of the adviser's inability (whether temporary or permanent) to provide those services."

Overview

The Proposing Release states that the Proposed Rule is "intended to help ensure that an adviser's policies and procedures minimise material service disruptions and any potential client harm from such disruptions." Specifically, the SEC is focused on operational risks "that may impact the ability of the adviser and its personnel to continue operations, provide services to clients and investors, or, in certain circumstances, transition the management of accounts to another adviser." The Proposing Release discusses a number of operational risks that can arise from both internal and external events and situations, including technology or systems failures, loss of key personnel, loss of access to physical locations and facilities, loss of adviser or client data, natural disasters, cyberattacks, terrorism and the loss of a service provider. The Proposing Release further states that operational risks can also arise when an adviser ceases or winds down its business, merges with another adviser, sells a portion of its business or commences bankruptcy proceedings. The Proposing Release provides examples of recent business continuity situations and transitions, including Hurricanes Katrina and Sandy and the 2008 financial crisis.

Proposed Rule 206(4)-4 would require advisers to adopt, implement and annually review a written business continuity and transition plan containing policies and procedures addressing: (i) business continuity following a significant business disruption and (ii) business transition in the event the adviser is unable to continue providing investment advisory services to clients.

Business continuity and transition plans

The Proposed Rule would require an adviser's business continuity and transition plan to be based on the risks of the adviser's operations and contain policies and procedures designed to minimise material service disruptions, including policies and procedures addressing certain specific components listed in the Proposed Rule.[9] Key components enumerated in the Proposed Rule are listed below, along with additional detail from the Proposing Release as to the items and actions the SEC believes should be addressed with respect to a particular required component.

- Maintenance of critical operations and systems, and the protection, backup, and recovery of data. An adviser's plan would be required to identify and prioritise critical functions, operations and systems (e.g. processing of portfolio securities transactions, valuation and maintenance of client accounts, and delivery of funds and securities). Furthermore, a plan should consider alternatives and redundancies to seek to maintain operations during a business-disruption event and identify key personnel for short- and long-term planning purposes. A plan should also address both hard copy and electronic backups of data, include an inventory of key documents with a list of key service providers and address the risks of cyberattacks.

- Pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees.
- Communications with clients, employees, service providers, and regulators.
- Identification and assessment of third-party services critical to the operation of the adviser.
- Plan of transition that accounts for the possible winding down of the adviser's business or the transition of the adviser's business to others in the event the adviser is unable to continue providing advisory services. A transition plan should account for: (i) transitions in both normal and stressed conditions and should be tailored for each client type, (ii) relevant contractual arrangements and (iii) the regulatory regimes applicable to the adviser. The Proposed Rule would require that the adviser's business continuity and transition plan include certain specific transition-related components, listed below.
  - Policies and procedures intended to safeguard, transfer and/or distribute client assets during transition.
  - Policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account. This information might include the identity of custodians, positions, counterparties, collateral and related records of each client.
  - Information regarding the corporate governance structure of the adviser.
  - Identification of material financial resources available to the adviser.
  - An assessment of the applicable law and contractual obligations governing the adviser and its clients. The Proposed Rule highlights various potential regulatory and contractual issues (e.g. cross-border regulatory issues, client consent requirements and automatic termination clauses).

Annual review

Proposed Rule 206(4)-4(a)(2) would require an adviser to review the adequacy of its business continuity and transition plan and the effectiveness of its implementation at least annually. In addition, the SEC states that such reviews should address any weaknesses identified in connection with any testing or assessments of the plan, as well as any lessons learned or changes made or contemplated as a result of an event triggering reliance on the plan during the year.

Timeframe for implementation

The Proposing Release does not include a proposed compliance date or timeframe. In addition, with the recent resignation of SEC Chairwoman Mary Jo White, and the ability of the new Trump administration now to name three Commissioners to the SEC, it is unknown whether the SEC will wish to move ahead with implementing the Proposed Rule in the near future.

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[1] Form ADV and Investment Advisers Act Rule, Rel. No. IA-4509 (Aug. 25, 2016) (Final Rule Release).

[2] The categories are: (i) exchange-traded equity securities; (ii) non-exchange-traded equity securities; (iii) U.S. government/agency bonds; (iv) U.S. state and local bonds; (v) sovereign bonds; (vi) investment grade corporate bonds; (vii) non-investment grade corporate bonds; (viii) derivatives; (ix) securities issued by registered investment companies or business development companies; (x) securities issued by pooled investment vehicles (other than registered investment companies); (xi) cash and cash equivalents; and (xii) other. Final Rule, Appendix D, Amended Form ADV, Part 1A, Schedule D, Section 5.K.(1). Notably, these asset categories are similar to those reported by advisers to private funds on Form PF.

[3] The six types of derivatives are: (i) interest rate derivatives; (ii) foreign exchange derivatives; (iii) credit derivatives; (iv) equity derivatives; (v) commodity derivatives; and (vi) other derivatives.

[4] A parallel managed account is defined in the Form ADV Glossary as follows: "With respect to any registered investment company or series thereof or business development company, a parallel managed account is any managed account or other pool of assets that you advise and that pursues substantially the same investment objective and strategy and invests side by side in substantially the same positions as the identified investment company or series thereof or business development company that you advise."

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act at Section 402.

[6] American Bar Association, Business Law Section, SEC No-Action Letter (Jan. 18, 2012) (ABA Letter) at Question 4; see also SEC Staff Division of Investment Management Response to ABA Letter (Aug. 10, 2006) (SEC staff provided guidance regarding interpretive issues raised by the decision in Goldstein v. Sec. and Exch. Comm'n, No. 04-1434 (D.C. Cir. June 23, 2006)).

[7] Specifically, the Final Rule did not expand the use of umbrella registration to: non-US filing advisers; exempt reporting advisers; advisers to other client types; or advisers not independently eligible to register with the SEC. Additionally, the SEC iterated that its statements regarding cross-border application of the Advisers Act are unchanged by the Final Rule, as are the Frequently Asked Questions on Form ADV and IARD, Reporting to the SEC as an Exempt Reporting Adviser. Final Rule Release Section II.A.3.

[8] *Adviser Business Continuity and Transition Plans*, Rel. No. IA-4439 (June 28, 2016) (Proposing Release).

[9] Tailoring may be based on the adviser's size or whether its technology infrastructure is primarily proprietary or outsourced.

THE ABCs OF THE GDPR: GETTING TO GRIPS WITH THE LATEST ACRONYM YOU NEED TO KNOW

Acronyms – they're everywhere. They've been gradually and innocuously infusing your daily vernacular and, before you know it, you LOL IRL at your BFFL's social media witticisms – KWIM? If that sentence has you reaching for Google or your nearest teenager for a translation, fear not: the apparent linguistic gulf between you and today's hottest acronyms may not be so wide as you think…

One of the most notable trending acronyms over the past six months at least – although probably not among the largest of Snapchat demographics – is the GDPR. After years of negotiation, and hundreds of pages of commentary, the General Data Protection Regulation (GDPR) was finally passed in May last year, setting not chat rooms but boardrooms across the globe aflutter in anticipation of its coming into force on 25 May 2018.[1]

Why has it caused such a reaction?

The GDPR was designed to build on the foundations of the current data protection framework laid down by Directive 95/46/EC (Directive), to:[2]

- Harmonise the data protection regime across the EU.
- Increase the rights of individuals and the accountability of organisations processing personal data.
- And empower data protection authorities (DPAs) to impose sanctions (for breach of the GDPR) of such significance and magnitude that they could be more aligned to the sanctions regimes under competition laws.

The ripples of anxiety have somewhat calmed since May (only to be aroused once more by the Brexit vote by the UK in June – but more on that later). As with most acronyms, there is more to the GDPR than meets the eye, and those four letters veil the depth of measures that companies need to implement to be compliant with the new legislation. This is where, in providing an introduction to some of the basic principles underpinning the GDPR, our ABCs can be of help.

First things first: why care?

Data forms the lifeblood of asset and fund management, influencing which investments are made, in what assets, when, for how long, and for whom. As the illustration opposite shows, the types of data held by managers is rather diverse, comprising statistical, financial and business data, as well as – crucially for our purposes – data relating to identified or identifiable individuals (i.e. personal data).

The European data protection regime is not concerned with the amount of personal data that organisations process. The fact that an organisation is processing personal data is sufficient for the law to apply. In this regard, the GDPR introduces two notable changes to the current regime:

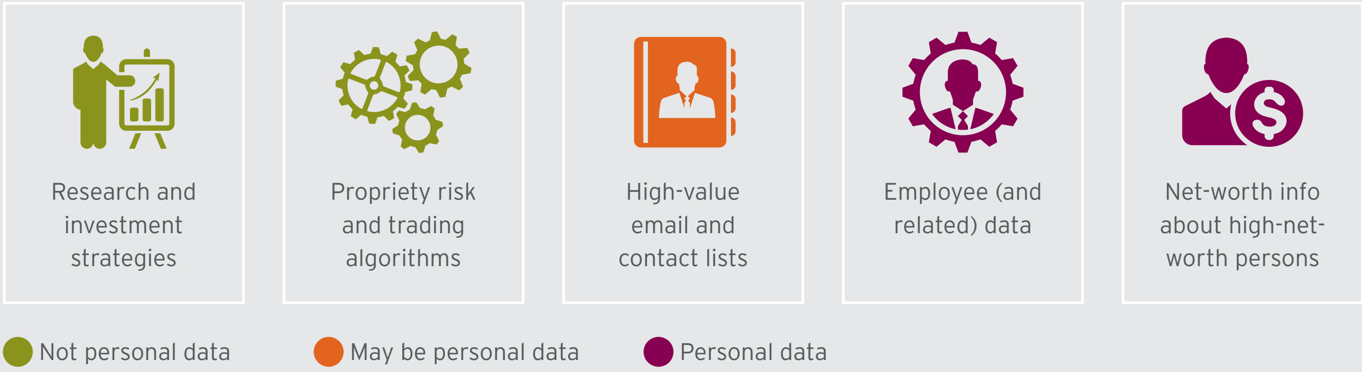
As a general rule, if you process personal data, you will be caught by European data protection laws

The current Directive applies directly only to persons that determine the purpose and means of data processing – i.e. data controllers. Data controllers must flow down certain of their data protection obligations to data processors (i.e. the persons who process personal data on their behalf) via contract. The GDPR, however, will apply directly to both data controllers and data processors, albeit to varying extents. In practice, this means that managers are likely to see a shift in the way that data protection provisions are negotiated with, for example, transfer agents and other service providers who will, from 25 May 2018, find themselves directly accountable to DPAs for their processing of personal data.

The long arm of the law is officially about to get a little longer

The GDPR expands the territorial reach of European data protection laws such that, in a move echoing the court's stance in the Google Spain case, European data protection legislation will apply to the processing of personal data:[3]

Types of data in a manager's data bank



- In the context of the activities of an establishment of a data controller or data processor in the EU, irrespective of whether the processing takes place in the EU;
- Or by a data controller or data processor that is not established in the EU, but that is processing personal data of individuals who are in the EU where those processing activities relate to the offering of goods or services to those individuals who are in the EU, or to the monitoring of the behaviour of those individuals insofar as their behaviour takes place within the EU..

With the above in mind, here are our ABCs of the GDPR.

A: Awareness

The ways in which data can be collected, generated, disseminated and used has multiplied exponentially with the growth in new technologies. It is therefore more important than ever for managers to ensure that they make individuals aware of their processing activities. Furthermore, the GDPR introduces an obligation on data controllers to notify most data breaches to the DPA (in the UK, this is the Information Commissioner's Office or ICO) without undue delay and, where feasible, within 72 hours of awareness of the breach.

However, this transparency with individuals and regulators can only be achieved if the manager itself has a good handle on the data processing activities that its business undertakes. The requirement for awareness is therefore twofold:

Awareness of individuals (aka transparency of processing)

One of the core principles of the GDPR is that personal data must be "processed lawfully, fairly and in a transparent manner".[4] The requirement for fairness in this provision requires fair processing information to be provided to individuals, and is not dissimilar to the requirements of the Directive. What is different is that that the rules in the GDPR relating to this provision of information:

- Emphasise that the information must be user-friendly and accessible.
- And are more prescriptive, setting out a fuller list of information to be provided to individuals including: the legal basis for processing, details of transfers to third countries and safeguards, retention periods for the personal data, and individuals' rights with respect to personal data.

Adopting the ICO's suggested "layered" or "blended" approach to the provision of this information (i.e. so that the information does not have to be provided in a single document, but instead can be provided via different channels) can help managers to adopt a pragmatic yet compliant approach to this transparency requirement.[5]

Self-awareness

The type of information that needs to be provided in a fair processing notice, as well as on a data security breach, necessarily requires managers to be intimately familiar with their data processing activities. The GDPR entrenches a number of tools that can be of help in this regard, some of which we highlight below.

Privacy impact assessments

Where a data controller is undertaking a type of processing (e.g. involving new technologies) that is likely to result in a high risk to rights and freedoms of individuals, the GDPR requires it to assess the impact of its data processing activities on the protection of personal data. This assessment should be undertaken before the processing is undertaken, and requires, e.g. a systemic description of the contemplated processing activities, and assessing the purpose of processing, legitimate interests pursued by the controller (if applicable), necessity and proportionality of the processing activities, the risks posed to the rights and freedoms of individuals, and the measures to be taken to mitigate the risks of processing.

This information would be expected to inform the performance of various obligations under the GDPR, including the content of fair processing information and any data breach notifications issued to regulators and affected individuals.

Privacy by design

The GDPR requires data controllers to implement appropriate measures (e.g. pseudonymisation) and to ensure that, by default, only personal data that is necessary for each specific purpose of processing are processed.

Data protection officer

If the core activities of a data controller or processor consist of processing that, by its nature, scope or purposes, requires regular and systematic monitoring of data subjects on a large scale, or they consist of processing on a large scale of special categories of data, then the data controller/processor must designate a Data Protection Officer (DPO) as part of its accountability programme. The DPO must, among other things, monitor compliance with the GDPR.

Given the type of processing typically undertaken by managers, this requirement for a DPO may not apply. The guidance issued by the Article 29 Working Party on 16 December 2016 will help to determine whether this is the case,[6] although the Article 29 Working Party has invited stakeholders to comments on this guidance until end of January 2017, so there is a chance that this guidance may change. In any event, note that this point should be assessed on a case-by-case basis and, even if a manager concludes that it does not need a DPO under the GDPR, it may be prudent to have a person holding such position to oversee general compliance with the GDPR.

B: Basis (for processing)

In addition to requiring fair processing, the GDPR also requires that personal data must be "processed lawfully, fairly and in a transparent manner".[7] To satisfy this requirement, at least one of the grounds for processing set out in the GDPR must be satisfied.[8]

Organisations typically assume that they need to obtain individuals' consent to process their personal data. The GDPR raises the threshold for valid consent and places the onus on the data controller to show that consent is freely given, specific and informed. This, coupled with the fact that consent can be withdrawn at any time, makes consent an uncertain premise to rely on to legitimise the processing activities.

Helpfully, consent is just one of a number of different ways of legitimising a manager's processing activities, and may not be required or appropriate where, for example, a manager can show that the processing is necessary for:

1) The performance of a contract to which the individual is a party (e.g. where the manager has entered into an investment management agreement with an individual, or an individual applies directly to a fund manager to subscribe for one of its retail funds).

2) Compliance with a legal obligation to which the manager is subject (e.g. anti-money-laundering rules).

3) Or the legitimate interests pursued by the manager or a third party (save where those interests are overridden by the interests and fundamental rights and freedoms of individuals).

Managers should therefore assess what data processing activities they undertake, and which of the lawful grounds for processing set out in the GDPR applies to each of those processing activities. Note also that this information needs to be provided to individuals via fair processing.

C: Cyber (and other security conundrums)

You only need to look at the news headlines of the past 12 months to know that security risks are among the most prominent threats to businesses today. Asset and fund managers are no exception to this, particularly given the type and the wealth of information that they process.

In addition to the requirements of the FCA Handbook, managers must ensure that they implement appropriate technical and organisational measures to ensure a level of security appropriate to the risk to, and to ensure integrity and confidentiality of, personal data.

Appropriate measures include:

- Encrypting personal data (both while it is stationary and in transit).
- Regularly testing and evaluating the effectiveness of the technical and the organisational measures.
- And taking steps to ensure that the personal data is only processed in accordance with the manager's instructions – practically, these could involve supplementing IT-based measures with appropriate internal policies to ensure that employees are fully aware of how they should treat personal data, escalation points and training.

While these types of preventative measures are clearly crucial to reducing the risk of a data security breach, it is equally important to have a robust remediation procedure in place. As mentioned above, security breaches must be notified to the DPA without undue delay and,

where feasible, within 72 hours of awareness of the breach. Where a security breach is likely to result in a high risk to the rights and freedoms of individuals, the data controller must also notify data subjects of the breach without undue delay.

Managers should therefore have clear policies and processes in place to be able to identify, and react to, security breaches in a timely manner. Otherwise, as demonstrated by the recent examples of the Yahoo data breach and the record GBP400,000 fine issued by the ICO to TalkTalk, organisations could find themselves dealing with significant commercial and reputational risks in addition to regulatory sanctions.[9]

s: sharing

As children, we were taught that "sharing means caring". This may certainly be the case when sharing data intra-group, or with domestic regulators. But the sharing of personal data with organisations in jurisdictions outside the EEA poses very different challenges to the sharing of personal data intra-country or even intra-EEA.

To transfer personal data outside the EEA, organisations tend to rely on a European Commission finding of adequacy in respect of the recipient jurisdiction, put in place standard contractual clauses approved by the European Commission (also known as "Model Clauses") or rely on the consent of the individuals whose data is to be transferred (among other derogations). Broadly, the GDPR builds on these mechanisms. However, key differences between the Directive and the GDPR include that the latter expressly recognises Binding Corporate Rules – for both controllers and processors – as mechanisms for intra-group cross-border transfer, and introduces a process for allowing transfers on the basis of certifications, provided that the relevant controller or processor applies the appropriate safeguards.

One of the biggest issues facing international organisations under the Directive is the question of how to reconcile compliance with European data protection laws with the demands for data by foreign regulators. The Directive does not lend itself easily to such disclosures, and there is often detailed risk analysis underpinning an organisation's decision as to whether to comply with European data protection requirements or acquiesce to foreign regulatory demands. The GDPR does not remediate this situation, which means that the issue of data transfers to foreign regulators remains a pertinent one for managers to grapple with for the foreseeable future.

GDPR aside, since 2015 we have seen a gradual unravelling of two of the key mechanisms for cross-border transfer. First in the line of fire was the Safe Harbor regime, which had allowed US organisations (other than financial services firms, for example) to self-certify compliance with the principles in the framework. This had the effect of deeming those organisations as providing an adequate level of protection to personal data.

On 6 October 2015, the Court of Justice of the European Union (CJEU) ruled that Safe Harbor was invalid,[10] and Safe Harbor was replaced with the Privacy Shield[11] earlier last year. The Privacy Shield is to be reviewed within a year of its implementation, but revelations last year in relation to Yahoo's scanning of millions of emails at the behest of the US government has made challenges to the adequacy of the Privacy Shield more likely.[12]

Now, as the fallout from the Schrems case continues, Ireland's Data Protection Authority has challenged the legality of Model Clauses in a case likely to be referred to the CJEU, and the European Commission has more recently proposed amending Model Clauses to allow DPAs to suspend businesses' data flows. This culminates from the CJEU's ruling in the Schrems case that the Commission had exceeded its powers in restricting national regulators' authority. Despite these challenges, for the time being Model Clauses still remain the most certain way in which managers can transfer personal data outside the EEA.

So now you know your ABCs…

Just as there are 22 other letters in the alphabet, there are various other requirements and restrictions in the GDPR that asset and fund managers should be aware of. From 25 May 2018, the risks of non-compliance with European data protection laws will be significant, particularly as non-compliant managers could find themselves facing a fine up to the higher of 4% of annual worldwide turnover and EUR20 million in respect of some breaches of the GDPR (e.g. breach of requirements relating to international transfers or the basic principles for processing), and up to the higher of 2% of annual worldwide turnover and EUR10 million in respect of others.

The quantity of personal data processed by a manager does not affect the extent to which it must comply with the GDPR, but naturally it – as well as the type of personal data and the frequency, purpose and duration of processing – will affect the organisation's risk profile. As technological advancements such as cloud computing, big data analytics, automation and blockchain technology incrementally revolutionise the behaviour and offerings of the financial services industry, and some managers seek to capitalise on the wealth of personal data within their groups (e.g. through vertical integration of data), managing the risks of non-compliance with European data protection laws with the rewards of innovation and business growth is becoming more challenging.

What about the other B word?

Prime Minister May has said that she intends to trigger Article 50 by end of March 2017, so, assuming this is the case, the UK looks set to leave the EU by summer 2019. This could mean that the GDPR is likely to be in force in the UK, in its current form, for at least 12 months until Brexit occurs. Even post-Brexit, there is unlikely to be a significant relaxation of the level of data protection managers are expected to provide when processing personal data in the UK. As a matter of policy, UK law would be likely to impose a broadly equivalent level of data protection to that agreed in the GDPR, not least because this is almost certain to be necessary to be considered an "adequate" jurisdiction to which personal data can freely be transferred from the EEA.

As Aristotle said: knowing yourself is the beginning of all wisdom

The GDPR forces organisations to be accountable for their data-processing activities and adopt a culture of data-protection compliance from the grass roots – via privacy impact assessments and implementing privacy by design – right through to top-tier management – via DPOs and severe sanctions for breach. As we edge ever closer to the dawn of the GDPR, it would be prudent for managers to conduct internal audits and draw up plans to assess where they are on the road to compliance and what they need to do to get there.

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Allen & Overy LLP

[1] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

[2] See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31995L0046&from=EN, last accessed on 24 October 2016.

[3] Google Spain SL, Google Inc. v Agencia Española de Protección de Datos (AEPD), Mario Costeja González, Case C-131/12, 13 May 2014.

[4] Article 5(1)(a), GDPR.

[5] See https://ico.org.uk/for-organisations/guide-to-data-protection/privacy-notices-transparency-and-control/, last accessed on 1 December 2016.

[6] http://ec.europa.eu/information_society/newsroom/image/document/2016-51/wp243_en_40855.pdf, last downloaded on 24 November 2016.

[7] Article 5(1)(a), GDPR.

[8] Article 6, GDPR.

[9] Yahoo: from https://yahoo.tumblr.com/post/150781911849/an-important-message-about-yahoo-user-security, last accessed on 24 November 2016. ICO: the significance of this fine is that it is the largest fine ever issued by the ICO, which has the ability to fine companies up to GBP500,000 for breach of the UK Data Protection Act. Reputational risk: see http://uk.reuters.com/article/us-verizon-yahoo-cyber-idUKKCN12D2PW, last accessed on 24 November.

[10] Case C-362/14 Maximillian Schrems v Data Protection Commissioner.

[11] See https://www.privacyshield.gov/welcome.

[12] "Yahoo Email Scanning Prompts European Ire" from http://www.reuters.com/, last accessed on 24 November 2016.

THE FOURTH EU ANTI-MONEY LAUNDERING DIRECTIVE: HOW WILL IT IMPACT THE ASSET MANAGEMENT AND INVESTMENT FUND INDUSTRIES?

Overview

The Fourth EU Anti-Money Laundering Directive (EU 2015/849)[1] (4AMLD), which came into force on 26 June 2015, will replace the Third Anti-Money Laundering Directive (2005/60/EC)[2] and must be transposed into the national law of Member States by 26 June 2017. On 5 July 2016, in response to terrorist attacks in Europe in 2015/2016 and the leak of the Panama papers, the EU Commission published proposals[3] to amend 4AMLD (which amendment proposals for the purposes of this article are referred to as 5AMLD), including, rather ambitiously, to bring the transposition date forward to 1 January 2017. The EU Council Presidency has issued no less than 5 compromise proposals to 5AMLD, finally agreeing its negotiating mandate on 20 December 2016 for discussions with Parliament. The Council Presidency has indicated that it seeks to conclude negotiations on 5AMLD by 30 June 2017, though the overall EU legislative process is still uncertain. The fifth compromise proposal of AMLD5 requires it to be transposed into the laws of the Member States within 12 months of publication, with a transition period of up to 36 months for certain provisions. The original 26 June 2017 transposition date for 4ALMD thus stands.

4AMLD is the latest significant upgrade to the EU legislative programme in this area which commenced in 1991 and has the aim of further strengthening the EU's defences against money laundering and terrorist financing and ensuring the soundness, integrity and stability, and confidence in the financial system as a whole. 4AMLD implements recommendations by the Financial Action Task Force (FATF). On some issues, 4AMLD expands on FATF's requirements and provides for additional safeguards. Like previous AML/CTF directives, 4AMLD is a minimum harmonising directive, providing Member States with the scope to adopt more stringent provisions if they so wish.

Key amendments for the asset management and investment funds industry

The principal amendments of 4AMLD/5AMLD, highlighted in the opposite section, reflect the most significant overall changes to be ushered in. Some will be more critical to the day-to-day landscape of those involved in the asset management and investment funds industries and these are examined in more detail below.

Risk-based approach and customer due diligence

Central to 4AMLD is greater emphasis on a risk-based approach to addressing money-laundering and terrorist-financing risks. Not only must Member States carry out risk assessments, but designated bodies (under 4AMLD these are called "obliged entities") will also be required to do so. The amplified emphasis in 4AMLD on risk assessment will also be reflected in changes to the current rules on customer due diligence (CDD). At present, certain automatic exemptions are available from the requirement to carry out simplified customer due diligence (SCDD) if the customer/investor is regarded as "blue-chip", e.g. a credit institution in the EU or third country with equivalent AML measures, or is a listed company. These important automatic exemptions will no longer be available under 4AMLD. Instead a decision to apply SCDD will require to be based on the obliged person's assessment that the relationship or transaction represents a lower degree of risk. Minimum lower-risk situations are set out in Annex II of 4AMLD.

Under 4AMLD enhanced customer due diligence (ECDD) will require to be carried out when dealing with natural persons or legal entities established in third countries identified by the European Commission as high-risk third countries and other cases of higher risk identified by Member States or designated

Principal amendments of 4AMLD/5AMLD

Greater emphasis on the risk based approach. Risk based assessments will be required to be carried out at European, Member State and individual institution level and be kept up to date. The European Supervisory Authorities (ESAs)[4] are required to issue joint opinions on Anti-Money Laundering/Combatting the Financing of Terrorism (AML/CFT) risks and the first joint opinions were required to be produced by 26 December 2016. Subsequent opinions should be issued every two years thereafter.

Extension of scope. Tax crimes are now included in the definition of "criminal activity" falling within the ambit of 4AMLD. Providers of gambling services are also brought within scope as are persons trading in goods for cash payments of at least EUR10,000. The extent to which Member States may decide that legal and natural persons engaging in a financial activity on an occasional or very limited basis, and do not fall within the ambit of the directive, will be curtailed. 5AMLD also brings virtual currency platforms and custodial wallet providers (i.e. persons who control access to virtual currencies) within scope.

Enhancement of beneficial ownership information. Corporate and other legal entities incorporated within their territory will be required to obtain and hold accurate and current information on their beneficial ownership. 4AMLD also imposes obligations on trustees of express trusts to obtain and hold information on beneficial ownership (please see commentary later in this article in relation to these points specifically).

Customer due diligence and politically exposed persons. 4AMLD substantially tightens rules on customer due diligence including in the areas of carrying out simplified due diligence, enhanced due diligence, the ability to rely on third parties to carry out due diligence and the extension of the rules relating to politically exposed persons to also cover domestic politically exposed persons.

Administrative sanctions. 4AMLD strengthens the sanctioning powers of Member States by introducing a set of minimum principle-based rules that Member States should ensure are available for systematic breaches of AMLD requirements. It also extends the powers of the financial intelligence units (FIUs) in the Member States. 4AMLD introduces greater administrative sanctions for breaches, including a maximum fine of at least twice the amount of the benefit derived from the breach or at least EUR1 million. For breaches involving credit or financial institutions, it provides for a maximum fine of at least:

- EUR5 million or 10% of the total annual turnover in the case of the institution.
- EUR5 million in the case of a natural person.

persons. The Commission has, by way of delegated Regulation effective 23 September 2016, published an initial list of high-risk third countries and it is anticipated that this list will be reviewed three times a year and be amended as appropriate. Minimum potential higher-risk situations are set out in Annex II of 4AMLD.

ECDD measures do not need to be invoked automatically with respect to branches or majority owned subsidiaries of EU obliged entities where these branches or subsidiaries fully comply with group-wide procedures and policies in accordance with 4AMLD.

By 26 June 2017, the ESAs must issue guidelines on the risk factors to be taken into consideration where SCDD and ECDD are appropriate. Draft guidelines were published in October 2015,[5] both generic and sector-specific, including for the investment management and investment funds sector.

ECDD is required to be carried out in respect of politically exposed persons (PEPs). 4AMLD widens the net of PEPs to include domestic (not just foreign) PEPs and also defines as PEPs "family members" and "persons known to be close associates". Obliged entities must have a procedure for identifying PEPs. Where a person ceases to have the characteristics of a PEP, the obliged entity must, for a period of at least 12 months thereafter, consider the continuing risk posed by that person and apply appropriate and risk-sensitive measures until such time as the person is deemed to pose no further PEP-specific risk.

As regards reliance on third parties carrying out initial CDD measures, 4AMLD specifically prohibits reliance on third parties established in high-risk third countries identified by the Commission, except in the case of branches or majority-owned subsidiaries of EU-obliged entities where these branches or subsidiaries fully comply with group-wide procedures in accordance with 4AMLD.

Under 5AMLD, the Commission intends to impose minimum ECDD procedures on obliged entities to ensure greater harmonisation across the EU.

Beneficial ownership registers

Under 4AMLD, in order to address perceived deficiencies in transparency around beneficial ownership, corporate and legal entities, trusts and similar structures will be required to hold adequate accurate and current information on their beneficial ownership.

"Beneficial ownership" is defined as any natural person who ultimately owns or controls a corporate or legal entity and/or on whose behalf the entity is conducting its activity. In the case of corporate entities, it relates to a natural person who ultimately holds a shareholding/controlling interest or ownership interest of 25% plus one share or ownership interest. The default position is that "if, having exhausted all possible means and provided there are no grounds for suspicion", the relevant entity does not identify a beneficial owner, or if the relevant entity has any doubt as about whether the person(s) identified is the beneficial owner, then the senior managers (including the directors and CEO) of the entity must be entered on the internal register as the "beneficial owners". In such circumstances, the entity must also keep records of all the steps taken to ascertain the beneficial owners. It should be noted, of course, that in the case of some corporate entities, especially UCITS and open-ended AIF funds, there may be not be any beneficial owners who are direct or indirect shareholders because of the broad-based ownership of many such funds. In such cases, details of the directors of the fund entity are likely to be required to be entered on the register as the default "beneficial owners".

Under 5AMLD, as originally proposed, the 25% ownership threshold is reduced to 10% in situations of entities that present a real risk of being used for money laundering and tax evasion. The Presidency Council compromise proposal does not, however, contain the 10% prescriptive requirement. Member States must ensure that the information on beneficial ownership is held in a central register in each Member State and that it must be accessible to competent authorities and FIUs, obliged entities when carrying out CDD measures and those who can demonstrate a "legitimate interest" in the information. Access to the information shall be in accordance with data protection laws and may be subject to online registration and the payment of a fee. Under 5AMLD, the Commission has proposed a requirement that details on beneficial ownership be made publicly available. These new requirements on beneficial ownership will be a significant departure for companies and other entities within the EU, particularly the requirement that registers be made publicly available. It will be challenging and costly for funds to obtain, maintain and update information which must be kept on the central register, particularly in the context of funds that permit dealing on a regular basis.

Trustees will also be required to obtain and hold information on beneficial owners. Where the trust gives rise to "tax consequences" Member States must also ensure that the beneficial ownership information held by the trustee is held on a central register. This will be an entirely new requirement for fund trustees, as unitholder register details are normally obtained and maintained by the fund's administrator on behalf of the trust fund, not the trustee of the fund. It remains to be seen as to the extent to which certain types of trust fund type arrangements may be included/excluded from the scope of domestic legislation in individual Member States and clarity is being sought by funds industry bodies as to whether or not certain trust funds will be caught by the new requirements.

In this regard, it should be highlighted that in terms of transposing the requirements of the 4AMLD into the UK legislative framework, that the transposition of the European level requirements are fully reflective of UK legal structures, and further that the responsibilities under the 4AMLD are correctly and unambiguously assigned to the parties most appropriate to perform these tasks.

For example, in the case of collective investment schemes, whatever their legal structure — Open-ended Investment Companies (OEICs), Unit Trusts or Authorised Contractual Schemes (ACS), responsibility for executing transactions in units/shares and maintaining unitholder/shareholder registers of the applicable scheme would normally fall on the Authorised Fund Manager (AFM) as operator of the scheme. Therefore it would appear practical and appropriate that it should be the AFM, as operator of the scheme, who would ensure money laundering obligations are properly performed.

What action is to be taken

4AMLD is a minimum-harmonisation directive and Member States have the power to impose more stringent measures delegated in the form of delegated acts and technical standards. Further regulation and guidance can be expected both at EU and Member State level between now and June 2017 and beyond. For example, in Ireland, Article 30(1) of 4AMLD (which requires companies and other corporate bodies to gather details on the beneficial ownership) has just recently been transposed so as to ensure that the information required to be sent to the central register will be available by 26 June 2017. Anyone promoting or servicing a fund, with responsibility for carrying out CDD for the fund on an outsourced basis, needs to consider preparatory work including:

- The requirement for the fund as an "obliged entity" to carry out an AML/CTF assessment under 4AMLD and review the impact this may have on various issues including CDD.
- Reviewing the fund's AML/CTF policy and other relevant documentation in the context of 4AMLD.
- Liaison, in the case of a fund and where relevant, with the fund administrator to ascertain the preparatory measures that the administrator is taking with regard to compliance with 4AMLD, including as to its identification of the fund's beneficial owners and its own policies and procedures and how they will affect the fund.

Trustees of funds established as trusts also need to consider the extent to which the trusts for which they act may be within scope and as to their potential compliance obligations. At present, it is not clear which trusts fall within the scope of 4AMLD and it is hoped that this uncertainty will be resolved to enable funds and service providers to comply with the provisions of 4AMLD on a timely basis.

Patricia Taylor
Partner
William Fry

[1] See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005L0060&from=en, last accessed on 26 October 2016.

[2] See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32005L0060&from=en, last accessed on 26 October 2016.

[3] See http://ec.europa.eu/justice/criminal/document/files/aml-directive_en.pdf, last downloaded on 26 October 2016.

[4] European Banking Authority (EBA) European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). Together, the "ESA's".

[5] See https://eiopa.europa.eu/Publications/Consultations/JC%202015%20061%20(Joint%20Draft%20Guidelines%20on%20AML_CFT%20RFWG%20Art%2017%20and%2018).pdf, last downloaded on 17 November 2016.

SHIFTING TIDES: DEVELOPING REGULATORY STRATEGY IN A DYNAMIC ENVIRONMENT

There has been a significant volume of commentary on the challenges that financial services industry stakeholders have experienced in trying to meet the demands of the evolving global regulatory agenda. While the majority has focused on the experiences of financial institutions adapting their business and operating models accordingly, there has been less analysis from the perspective of regulators who, having developed regulatory strategy in the post-financial crisis environment, must endeavour to strike a balance between economic growth and greater systemic stability. This article, however, takes one such perspective.

Considering the Central Bank of Ireland's Strategic Plan 2016-2018,[1] this article examines the Central Bank's regulatory priorities concerning the asset management and investment funds industry in particular, and assesses progress to date and possible future developments.

As acknowledged by the Central Bank repeatedly in its Strategic Plan, the priorities are devised in a dynamic environment of change for central banking and financial systems in Ireland and Europe. Accordingly, the possibility that elements of the plan may be overtaken by events that may not have been foreseen at the commencement of the three-year planning cycle is recognised by the commitment to carry out an annual review of the plan.

A stark example of one such event was the June 2016 referendum on the UK's withdrawal from the European Union. This article will consider the likely (and in some cases already evident) impact of the Brexit vote on the Strategic Plan. It will also consider the manner in which market and/or global regulatory developments in areas such as cybersecurity, investment fund pricing, corporate governance and anti-money laundering have been translated into regulatory initiatives in Ireland.

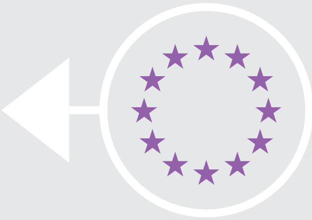
Strategic planning and enforcement

The Strategic Plan is published every three years and sets out the future priorities, activities and desired outcomes under each of the regulator's main areas of statutory responsibility. These responsibilities cover: price stability; financial stability; consumer protection; supervision and enforcement; regulatory policy development; payment, settlement and currency systems operations and oversight; economic advice and financial statistics; and recovery and resolution of distressed financial services firms. The Strategic Plan is not limited to the asset management industry and considers all entities subject to Central Bank supervision, including the banking, insurance and securities sectors.

One of the principal methods by which the Central Bank carries out its responsibility of supervision and enforcement is through its annual programme of themed inspections, which is published at the beginning of each year.[2] In announcing its programme of themed inspections for 2016, the Central Bank indicated that entities deemed to be low impact under its risk-based supervision framework, including collective investment schemes and their service providers, would be subject to increased inspections in future.[3] In light of this, the Central Bank has devoted a team to low-impact funds. This new approach followed a number of peer reviews conducted between 2013 and 2015, which suggested that there was possibly an undue weight of focus on high-impact firms. Of the 12 themed inspections outlined in the 2016 programme, eight were of relevance to the asset management industry.

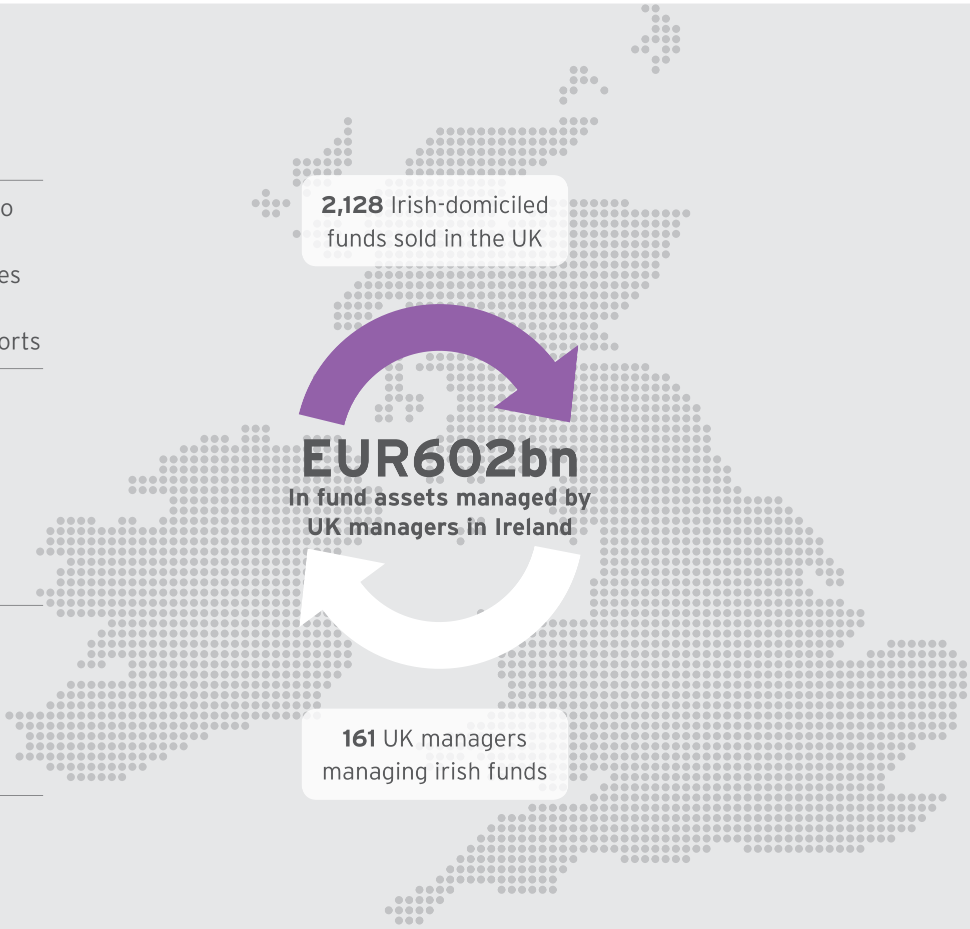
The impact of Brexit on strategic planning

The UK has been central to the growth and development of the investment fund industry in Ireland, with 2,128 Irish-domiciled collective

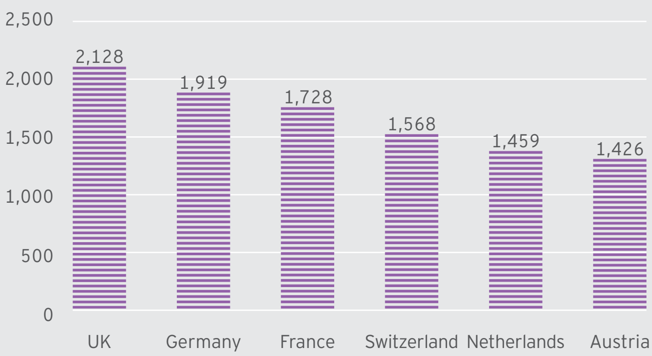


Distribution to **26** other EU Member States via UCITS or AIFMD passports

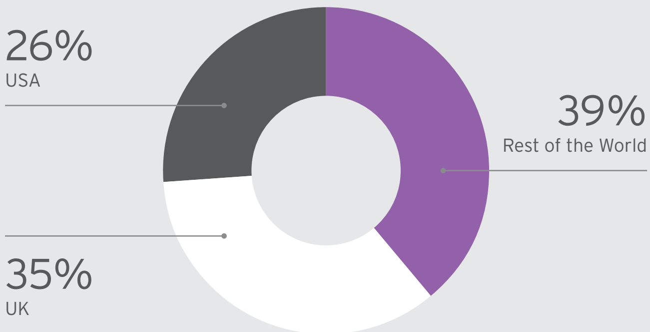
Distribution to over **70** countries across the globe



Number of Irish funds registered for sale



Promoter origin of Irish-domiciled investment funds



Source: Irish Funds Industry Association

investment schemes registered for sale in the UK and over 160 UK-based fund managers of Irish domiciled funds, more than from any other country.

The chart above provides some indication of the scale of the relationship between the two jurisdictions.

As UK asset managers evaluate their options to maintain EU access in the wake of Brexit, Ireland has consistently appeared on the short list of potential jurisdictions, with industry surveys highlighting its talent pool, common-law legal system, proximity and use of the English language as key advantages over competitors.[4]

One priority for UK asset managers after Brexit will be to ensure that they can continue to manage Irish-domiciled funds on a delegated basis. UK managers are currently able to use a fast-track clearance on the basis that they fall within scope of a number of EU directives (MiFID,[5] UCITS,[6] AIFMD,[7] credit institutions,[8] etc.).

This process is likely to fall away in the event of a "hard Brexit" that is, the UK giving up full access to the single market for goods and services and full access to the customs union in return for gaining full control over its own trade deals, its own law-making, and its own immigration policy, but it should be possible for UK institutions to continue to act in respect of Irish funds on the basis that the UK has a model of prudential regulation comparable to EU requirements. In this regard, it is worth noting that Prime Minister May has indicated her intention to pass a "Great Repeal Bill" prior to Brexit, thereby enshining current EU law into UK domestic law. Accordingly, UK investment managers of Irish domiciled funds should be able to find themselves in an analogous position to the many investment managers from various jurisdictions including the USA, Hong Kong, Singapore, Brazil, South Africa, Dubai and others that have been approved by the Central Bank to manage Irish-domiciled funds.

Brexit also presents a clear impetus for UK management companies to consider the establishment of a base in the EU in order to continue to have the current level of access to the EU market (and, in particular, the authority to allow sales teams to operate within the EU). This may be done by establishing an Irish entity with a relevant EU licence, whether as a UCITS management company, AIFM or MiFID firm.

All this has the potential to affect the Strategic Plan published in November 2015 — a time when the prospect of a positive vote in the UK's referendum on its withdrawal from the EU appeared an unlikely scenario. The Central Bank identified a number of critical factors or "strategic enablers" that must be managed to achieve the aims of the Strategic Plan. These included the areas of people and knowledge and information and resources. In the wake of the Brexit vote, the Central Bank has had to react swiftly to external events and no doubt reconsider elements of its Strategic Plan. One immediate step taken was to split its Markets Supervision Directorate into two units as it deals with a surge of inquiries from London-based investment funds and firms following the Brexit referendum — an Asset-Management Directorate and a Securities and Markets Directorate.[9] To ensure sufficient capacity, it has also been reported to be seeking to

We stand ready to do our job. We are open for engagement.

Gerry Cross, Director of Policy and Risk, Central Bank attract staff with experience of working in the UK Financial Conduct Authority (FCA).[10]

In a speech delivered in October 2016, Gerry Cross, the director of Policy and Risk at the Central Bank, acknowledges some of the challenges for Ireland and the Central Bank when speaking about the implications of Brexit for the Central Bank's regulatory and supervisory mandate.[11] Cross notes the potential for a material increase in the number of applications for authorisation in Ireland due to the possible loss of passporting rights of UK-authorised entities.

As part of his update, Cross also confirms that the Central Bank will not offer fast-track authorisation to a firm already licensed by the UK authorities, noting that "to carry out our ongoing oversight effectively, it is important to have carried out a good quality authorisation process so that we have an understanding of the business and the risks and how they are managed". He also notes that the Central Bank will need to be satisfied that it is authorising a business or line of business that will be run from Ireland and which it can effectively supervise.

Any outsourcing by the relevant firm should be in accordance with practice that has been allowed by the Central Bank to date, and in agreement with international practices and standards.

Importantly, however, Cross goes on to note that an entity that has been authorised and is currently supervised in the UK should be "in a good position to understand what is expected in processes such as these and should be in a position to quickly get a complete application together". He also confirms that the Central Bank is open to meeting and engaging with firms in advance of a completed application, which can be particularly helpful in more complex cases. In terms of capacity, he confirms that the Central Bank is committed to being in a position to discharge the work in processing what could be a large influx of applications within a short period of time and to carry out the related oversight activities that will be required. In this regard, he notes that workforce planning for 2017, which is currently being finalised, reflects the additional resources required to deal with applications that may be made to the Central Bank and that the Central Bank will staff-up as necessary.

Cross expressed similar thoughts and sentiments in a more recent article on "Responding to the post-Brexit environment".[12] In that article, Cross acknowledges that a key component of a successful and attractive jurisdiction for the location of financial services activities is a strong and independent regulator, with international credibility and that delivering this is by far the most valuable contribution the Central Bank can make to the attractiveness of the jurisdiction as a location for financial services firms.

The Central Bank has indicated that firms seeking authorisation in Ireland will find the Central Bank to be "engaged, efficient, open and rigorous".[13]

We believe that these comments, added to those in Cross's speech referred to above, reflect the clear intent of the Central Bank to engage with the increasing workload that may flow from Brexit (whatever form it takes) and to incorporate such changes into the Central Bank's strategic planning. In this regard, we believe that there is an opportunity for industry here in Ireland to assist the Central Bank in achieving this aim. For example, one practical step would be for industry to assist the authorisation process by clearly and comprehensively mapping the approval and supervision process applied by the FCA against equivalent Central Bank requirements. If this is shared with the Central Bank, it could assist the approval process by allowing the Central Bank to focus on those areas where its processes diverge from those of the FCA, while leveraging the overlap between the regulatory regimes. It will be important for the Irish industry to explore other ways in which the Central Bank may be in a position to fast-track certain aspects of the authorisation procedure while continuing to meet its mandate to ensure prudential soundness, ensure financial stability and protect consumers and work is ongoing on this process.

Regulating cyber risk

One area addressed in the programme of thematic inspections for 2016 that clearly illustrates the challenge of regulating in an ever-changing environment relates to information technology risk or cybersecurity.[14]

Cybersecurity risks and threats have been present since the dawn of the information technology age. However, in recent years, reported cyberattacks and cybersecurity breaches are becoming more significant and more sophisticated in terms of their impact, attracting mainstream media headlines with allegations of state-sponsored hacking programmes against other sovereign states and financial institutions. Unsurprisingly in this context there has been increased attention at international level on the issue, with the International Organisation of Securities Commissions (IOSCO) and the Committee on Payments and Market Infrastructures issuing guidance on cyber resilience for financial market infrastructures in June 2016.[15] This trend has played out at a domestic level, with the Central Bank increasing its focus on this area every year and two separate rounds of guidance issued to industry participants.

In February 2015, the Central Bank identified cybersecurity and operational risk, together with the inspection of controls and procedures around system security and access, as an area of focus in its programme of themed inspections.[16] Throughout the course of 2015, it also conducted a number of reviews of the cybersecurity policies and procedures of a variety of financial institutions. This led to the publication of a letter to industry stakeholders in September 2015, setting out examples of best practice arising from its thematic review.[17]

In 2016, IT risk, focusing on the resilience of firms' IT systems, was included in the programme. This process led, in turn, to formal *Cross-Industry Guidance in Respect of Information Technology and Cybersecurity Risks*, published in September 2016. The guidance addresses the role of the board and senior management in the oversight of IT and cybersecurity risks, but also addresses IT-specific governance and risk management, including risk management frameworks, disaster recovery, business continuity planning, change management and outsourcing of IT systems and services.

Expressly recognising the rapid developments in this area, the Central Bank's guidance notes that it does not address all aspects of the management of IT and cybersecurity risk, but rather focuses on those areas that the Central Bank deems most pertinent at that time based on the supervisory work carried out to date. However, firms would be wise to have due regard to the importance afforded to cybersecurity as a strategic priority by the Central Bank, as inevitably increased regulatory focus brings with it an increased risk of regulatory sanctions for breach where systems and processes are deemed to fall short of required standards.

Investment fund costs

The issue of investment fund costs has moved up the regulatory agenda in recent times, with the European Securities and Markets Authority (ESMA) commencing supervisory work on potential "closet index tracking". National regulators in the UK, Denmark, Norway and Sweden are also looking at issues related to the disclosure of investment fund fees, while investor protection group Better Finance has announced that it will carry out its own closet-tracking probe after ESMA refused to name and shame the funds it suspected as potentially being mis-sold.

This trend was reflected in Ireland with the 2016 programme of thematic inspections confirming that the Central Bank would conduct an analysis of the production costs of investment funds.

As part of its analysis, the Central Bank stated that it would focus on the effectiveness of disclosures regarding costs and fees. While the rules regarding prospectus and UCITS KIID disclosures provide a clear framework, in the Central Bank's view, it is not clear that the application of the rules permits investors to make an informed decision and to differentiate between funds. The Central Bank undertook to conduct a statistical analysis relating total expense ratios with the various characteristics of Irish-domiciled funds. Outliers would be identified to determine whether further follow-up supervisory work may be warranted.

The statistical analysis would use data available to the Central Bank already in the form of funds' regulatory returns.

Corporate governance

Corporate governance for investment funds and fund managers has been a focus for the Central Bank since its inclusion in the 2014 programme of themed inspections, leading to the publication of the Central Bank's *Consultation on Fund Management Company Effectiveness* – Delegate Effectiveness in September 2014 (CP86)[18] and to the publication of final guidance on directors' time commitments, organisational effectiveness, delegate oversight, managerial functions, operational issues and procedural matters in December in 2016.[19] The issue of directors' time commitments continued to be a component of the themed inspection programme in 2016, with a particular focus on directorships with extensive sub-fund commitments. While CP86 is a domestic initiative, it is clear that the Central Bank has had regard to global trends in relation to substance and the management of risk. The focus has been on ensuring that the Central Bank will, at all times, remain in a position to effectively supervise Irish-authorised management companies.

It would be reasonable to speculate that the outcome of the Brexit referendum had an impact on one of the proposals made by the Central Bank prior to the date of the UK referendum. In its proposals published in June 2016, the Central Bank had proposed a location rule, requiring that two-thirds of designated persons or directors of Irish management companies be resident in the EEA. While the rationale advanced for this rule at the time suggested that UK-based persons would continue to be eligible following Brexit (and the potential departure of the UK from the EEA), the vote arguably required the Central Bank to recast this requirement, particularly in light of the relationship between Ireland and the UK.

The final form of the location rule, as published in December 2016, is that half of the designated persons or directors of Irish management companies be resident in the EEA and that half of the managerial functions be performed by at least two designated persons resident in the EEA.[20] The Central Bank has sought to provide a degree of comfort to fund management companies with directors and designated persons located in the UK, as they plan for the post-Brexit regulatory environment. While the Central Bank is understandably unable to be definitive about whether UK resident individuals will meet the test for effective supervision until after the final terms of the UK's exit from the EU are known, the Central Bank's feedback statement includes a lengthy list of criteria taken into account by the Central Bank in determining its ability to exert effective supervisory influence over a fund management company and its management. We believe those criteria should apply to UK resident individuals regardless of the final terms of Brexit.

Anti-money laundering

Although not expressly referred to in either the Strategic Plan or the 2016 programme of themed inspections, countering money laundering and terrorist financing is likely to remain high on the regulatory agenda, particularly following Ireland's FATF mutual evaluation review in 2016.

In a briefing to the industry in December 2015, the Central Bank indicated that the outcome of the review may lead to an increase in legislation and regulatory supervision in this area. As well as addressing possible new measures at a national level in 2017, industry stakeholders must also address the implementation of the EU Fourth Money Laundering Directive by 26 June 2017. Certain provisions regarding the beneficial ownership of corporates and other legal entities have already been transposed into Irish law, with the passing of the European Union (Anti-Money Laundering: Beneficial Ownership of Corporate Entities) Regulations 2016 in November 2016. The new provisions require corporates and other legal entities incorporated in EU member states to obtain and hold adequate, accurate and current information on their beneficial owners and each entity must set up a beneficial ownership register. The requirements were transposed early in Ireland to ensure that the central register required to be created under the EU Fourth Money Laundering Directive can be populated with the relevant information from June 2017. Again, the publication of these regulations to coincide with the FATF mutual evaluation review is illustrative of the potential of external events to impact on regulatory planning.

Future developments

While the Brexit vote has led to considerable uncertainty, the Central Bank's preparations and planning for a possible "leave" vote in advance of the UK referendum, its extensive experience in working with industry stakeholders to create a prudent but practical regulatory environment sensitive to needs of international fund managers, while honouring its mandate of safeguarding stability and protecting consumers, and its recent organisational restructuring and increased capacity via ongoing recruitment all point to a positive environment for those UK firms seeking to relocate their operations to an EU jurisdiction.

In terms of ongoing and future strategic priorities, a continued focus on cyber risk and security, corporate governance, anti-money laundering and the costs and fees charged by investment funds are likely to appear high on the regulatory agenda for the foreseeable future. The Central Bank's positive track record in being responsive and reassessing its regulatory priorities to react to external events looks set to continue.

Shay Lydon
Partner

Brónagh Maher
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Matheson

[1] Plan from https://www.centralbank.ie/publications/Documents/Strategic%20Plan%202016%20-%202018.pdf, last downloaded on 24 October 2016.

[2] From https://www.centralbank.ie/regulation/processes/consumer-protection-code/compliance-monitoring/Pages/themed-inspection.aspx, last accessed on 24 October 2016.

[3] Framework, viz PRISM — the Probability, Risk and Impact System.

[4] See "Ireland Edges Ahead of Lux in Brexit Battle, Ignites Europe, 8 August 2016 at www.igniteseurope.com. A subscription service, last accessed on 10 November 2016.

[5] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

[6] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

[7] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers.

[8] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

[9] See "Irish Regulator Creates Fund Unit in the Wake of Brexit Vote", Ignites Europe, 20 September 2016, last accessed online on 10 November 2016.

[10] See "Ireland Moves to Attract UK Regulatory Staff", Ignites Europe, 6 September 2016, last accessed online on 10 November 2016.

[11] Central Bank Speech "Brexit and Financial Services" Director of Policy and Risk Gerry Cross speaking at Deloitte Ireland Brexit Briefing 3 October 2016, available at http://www.centralbank.ie/press-area/speeches/Pages/DirectorofPolicyRiskGerryCrossspeakingatDeloitteIrelandBrexitBriefing.aspx, last accessed on 30 November 2016.

[12] See "Responding to the post-Brexit environment" 23 December 2016 available at http://www.centralbank.ie/press-area/speeches/Pages/RespondingtothepostBrexitenvironmentGerryCross.aspx, last accessed on 4 January 2017.

[13] See "Firms seeking authorisation in Ireland will find the Central Bank to be engaged, efficient, open and rigorous – Deputy Governor Cyril Roux" 1 December 2016 available at http://www.centralbank.ie/press-area/press-releases/Pages/FirmsseekingauthorisationinIrelandwillfindtheCentralBanktobeengagedefficientopenandrigorousCyrilRoux.aspx, last accessed on 4 January 2017 and "Responding to the post-Brexit environment" 23 December 2016 available at http://www.centralbank.ie/press-area/speeches/Pages/RespondingtothepostBrexitenvironmentGerryCross.aspx, last accessed on 4 January 2017.

[14] The other areas addressed were outsourcing arrangements; alternative investment fund managers' programme of activities; the risk function; production costs of investment funds; use of financial indices as eligible investments for UCITS investment funds; director time commitments; review of client asset management plans for investment firms; review of suitability assessment of clients; examination of information provided to clients on an ongoing basis; hedging arrangements at share-class level for investment funds; and a review of the practices of firms when dealing with insider information and their compliance with the Market Abuse Regulations (Regulation (EU) No 596/2014).

[15] Guidance on cyber resilience for financial market infrastructures June 2016 Committee on Payments and Market Infrastructures and Board of the International Organization of Securities Commissions ISBN 978-92-9197-288-3 (online).

[16] Central Bank Information Release 26 February 2015 "Central Bank publishes programme of themed inspections in Markets Supervisions, available at https://www.centralbank.ie/press-area/press-releases/Pages/CentralBankpublishesprogrammeofthemedinspectionsinMarketsSupervision.aspx, last accessed on 30 November 2016.

[17] Central Bank letter dated 22 September 2015 re Review of the management of operational risk aeound cybersecurity within the Investment Firm and Fund Services Industry, available at https://www.centralbank.ie/regulation/industry-sectors/investment-firms/mifid-firms/Documents/Industry%20Letter%20-%20Thematic%20Review%20of%20Cyber-Security%20and%20Operational%20Risk.pdf, last downloaded on 30 November 2016.

[18] From https://www.centralbank.ie/regulation/marketsupdate/Documents/CP86%20Fund%20Management%20Company%20Effectiveness-Delegate%20Oversight.pdf, lasted downloaded on 24 October 2016.

[19] From http://www.centralbank.ie/regulation/marketsupdate/Documents/161219_FINAL%20FUND%20MANCOS%20GUIDANCE%20_CD%20(002).pdf, last downloaded on 4 January 2017.

[20] See Central Bank "Feedback Statement on CP86 – Consultation on Fund Management Company Effectiveness – Managerial Functions, Operational Issues and Procedural Matters" available at http://www.centralbank.ie/regulation/marketsupdate/Documents/161219_CP86%20FEEDBACK%20STATEMENT_THIRD%20CONSULT_FINAL_RHD%20(002).pdf, last downloaded 4 January 2017.

HOW TO GET COMFORTABLE WITH PERSONAL ACCOUNTABILITY

The Senior Managers and Certification Regime (SM&CR) will be extended to all FSMA-authorised firms from 2018.[1] For senior managers at these firms, whether in the UK or elsewhere, what can you do now to be comfortable with the scrutiny and personal accountability that will come with the SM&CR?

The SM&CR, like many recent regulations, has its origin in the 2008 financial crisis. The SM&CR is a response from regulators to improve professional standards and culture in the UK financial services profession, and it is still evolving. Its aim is to ensure that senior managers are held accountable for any misconduct that occurs in their areas of responsibility. Andrew Bailey, then deputy governor of Prudential Regulation at the Bank of England and subsequently the CEO of the Prudential Regulatory Authority (PRA) before becoming the current CEO of the Financial Conduct Authority (FCA), underlined the purpose of the SM&CR on the day it came into force for banks and insurers: "Appropriate and robust accountability for senior managers in financial institutions is a crucial part of the effective functioning of the economy… You can delegate tasks but you cannot delegate responsibility."[2]

Following consultation, the SM&CR will be extended to all FSMA-authorised firms from 2018, bringing asset and wealth managers into scope. While the details of how the SM&CR will be applied to these firms have not yet been defined, the underlying principles of individual accountability remain, and it is likely that the regime will be similar to that applied to banks and insurers. There is an opportunity to do work in advance of the final rules to put your firm in the best position to support its senior managers and ensure that they can fulfil their responsibilities. A holistic review will also help preparations for other new regulatory requirements, such as governance arrangements under MiFID II.

Understanding the SM&CR as applied to banks and insurers

Implementing the Senior Managers Regime (SMR) requires senior managers' responsibilities to be clearly apportioned. It should be clear to the individual, the senior management team and regulators who is accountable for specific functions. A Statement of Responsibilities (SoR) for each individual carrying out a senior management function must be submitted to the regulators along with an overall responsibilities map that sets out where senior managers and other senior individuals fit in the governance structure. There are prescribed responsibilities that have to be allocated to senior managers, which include specific risks such as financial crime. In addition to apportioning responsibilities, firms must assess senior managers' fitness and propriety before submitting applications to the regulator, and at least annually thereafter.

When issues arise, regulators will look to the SoRs to identify the relevant senior manager. They will want to understand what was done to control the risk, the rationale behind decisions taken and actions taken to remedy the situation. Where responsibilities are delegated, regulators will want to establish if delegation was appropriate and effectively overseen. This raises the question of how much oversight to apply and how much reliance senior managers place on staff lower down in the organisation.

The SMR is supplemented by the Certification Regime (CR) and Conduct Rules. The CR applies to staff that pose a significant risk to the firm or its customers. Firms must identify certified individuals and assess their fitness and propriety at least annually. The Conduct Rules apply standards of conduct to staff at all levels of the organisation, including non-executive directors captured by the SMR. They are readily recognisable, flowing from the statements of principle for approved persons, and include acting with integrity, due skill care and attention, cooperating with regulators, treating customers fairly and observing proper market conduct standards.

The CR and Conduct Rules set standards for all staff (with the exception of ancillary staff), but place responsibility on firms to ensure

standards are being maintained. Firms need to think about how they make sure all staff, not just senior managers and certification staff, are behaving as they should.

Learning from the implementation of the SM&CR in banks and insurers

A considerable amount of detailed work is required to implement the SM&CR, so firms captured by the regime in 2018 should be thinking now about how to prepare. Asset and wealth managers can benefit from the banking and insurance sectors' experience to address the challenges of the SM&CR.

There are a number of areas that banks and insurers have found difficult when considering the SM&CR. The first is defining the boundary of responsibilities between senior managers. While some responsibilities will be straightforward to allocate, others may need to be carefully segregated between different senior managers and in some occasional cases shared. Individuals overseas also need to be considered, and those who have influence over the UK firm need to be included in the SM&CR. Gaining clarity on where responsibilities lie in practice can be difficult. Scenarios can help test where responsibilities fall as the management team works through its response to a situation.

As well as the initial implementation, the SM&CR needs to be built into firms' ongoing practices. This includes ensuring that existing and new staff understand the implications of the SM&CR. Another challenge is keeping the allocation of responsibilities up to date as this will need amending when restructures and role changes are executed. To manage the ongoing requirements of the SM&CR, some firms have established specific teams to run and maintain arrangements.

There is also the question of what evidence is sufficient to demonstrate that senior managers have discharged their responsibilities. This will be different for each senior manager. While formal records such as committee minutes and management information will help, thought also needs to be given to whether any additional records are required for key decisions or delegation that occurs outside the formal arrangements. Firms will need to take this into account and provide support to their senior managers.

Finally, while working through the detail of how to implement the SM&CR, it is important that firms do not lose sight of the spirit of the regime. Bearing this in mind should help deliver the outcomes the regulator is looking for.

Extending the SM&CR to other authorised firms

Effective governance, operational and control frameworks help senior managers discharge their responsibilities and provide comfort that the business is operating appropriately. When delegating tasks, senior managers must be able to rely on their staff. Culture drives the way decisions are made and can help make sure staff act as the senior manager would expect.

Now is a good time for firms to review governance and culture, as both can take time to change. Ensuring changes are embedded ahead of the SM&CR will put senior managers and their firms in the best position to feel confident in their responsibilities and delegation.

When supervising firms, the FCA is interested in outcomes. For asset managers, this includes your interaction with markets and the service you provide to investors in your funds. There has been a strong push from the FCA for asset managers to think about the underlying investors in funds, rather than just the distributors that appear on the register.

Firms need to consider how they act on behalf of those underlying customers. Are you giving them what they would expect from your communications? Are you getting the best deal for those customers, limiting costs to maximise the performance you generate? For senior managers, they need to consider their responsibilities and the outcomes being delivered.

One of the FCA's current business plan priorities is firms' culture and governance. Both governance and culture can be powerful drivers in delivering the right outcomes for investors, and have been areas of regulatory interest for some time. Scrutiny of these topics is likely to increase under the SM&CR.

It is difficult to take a dispassionate look at your own governance and culture. Firms do not set out to build an environment that generates the wrong results, but drivers can build up over time, generating behaviours that become self-reinforcing. For example, seeing praise and promotion given to individuals who take an aggressive line to the detriment of their customers can drive other staff to take a similar approach. This will not produce the best outcomes for investors in funds.

Firms captured by the regime in 2018 should be thinking about how to prepare.

Ensuring senior managers fulfil their responsibilities

The starting point for senior managers is to be clear about what they are responsible for and that this corresponds with what happens in practice. But governance is not just about individuals: it is also about how the members and different parts of the governance structure operate together.

The SM&CR provides an opportunity to take the time to carefully review how your business makes decisions, oversees delegation and drives behaviours.

Effective discussions and decision-making need the right people in the right place at the right time with the right information. The composition of the governance bodies is important to make sure decisions are rigorously tested. Appropriate membership ensures that relevant input is provided and decisions are based on a diversity of views. At board level, non-executive directors can provide a useful perspective, independent of the business.

It is important that the members of a forum contribute to make sure the important questions are asked and answers are tested. Skills and experience need to be appropriate to the responsibilities placed on the individual, and should be reviewed for current members and when planning for succession. In identifying potential successors, firms should also bring more diverse experience and backgrounds onto boards to drive the best possible decision-making at the top of the business.

Governance membership at boards and committees further down the organisation will differ depending on the types of discussion (e.g. detailed or strategic) and the issues being decided. Whether a particular forum contains the relevant business lines (e.g. operations, risk, compliance, human resources) should be part of senior managers' considerations when delegating tasks to other committees.

Reporting and escalation routes need to be clear so senior managers are kept appropriately informed of important changes, decisions and issues. A complex or convoluted governance structure can lead to issues not getting escalated to the right place, or not being escalated quickly enough up the chain to allow fast and effective decision-making.

An important aspect of reporting is the quality of information provided to boards or committees. The scope and level of detail of the information provided should allow those present to understand, check and challenge it. This may involve summarising data and trends and presenting them in a digestible format. Providing all possible information is often counterproductive for effective governance as the volume makes it unlikely that it will be read or appropriately scrutinised. One compliance officer made the following observation: effective reporting is providing information, not data. Keeping this in mind can improve the quality of reporting so senior managers are better informed.

Relying on subordinates to make the right decisions

Governance provides a framework for decision-making, delegation and reporting. Even with the best reporting, senior managers cannot oversee everything all the time. Senior managers must delegate tasks appropriately to the right people, and culture can influence those individuals to make the right decisions, delivering the outcomes customers expect. Asset management is the business of trust, and the reputational risk from a poor culture should not be underestimated.

Assessing and changing culture are difficult tasks, particularly from within a company. Culture must be inferred from many observations of how firms and different individuals make judgements. What was considered, what was discounted, what tipped the balance of decisions?

There are many influencers of behaviour, from the tone of conversations to what actions are rewarded. Senior managers are in a powerful position to drive the right outcomes and can use a number of different tools. To start, what do you look for when recruiting? During the selection process do you test the judgements they would make, ideally using examples from their own experience? For those already employed, what is considered when talking about compensation and promotion? Is it just financial performance, or do other measures such as their behaviour feed into the assessment? If people in your company see types of conduct being sought from new joiners or rewarded in their peer group, they will want to mirror those behaviours, good and bad.

Turning to best execution as a case study

Best execution has received a lot of attention lately, and the FCA is likely to continue its interest. Best execution requirements are changing under MiFID II, and there is also a growing focus on best execution in fixed income.

From the perspective of the SM&CR, best execution should sit within the responsibilities of a senior manager who understands the relevant risks and requirements. Indeed, this was good practice identified by the FCA in its "Best execution and payment for order flow" thematic review.[3]

The senior manager will need to rely on those executing trades to achieve best execution, and may also delegate oversight of best execution. The behaviour of the individuals to whom best execution tasks have been delegated will be shaped by the firm's policies, procedures and controls, but also by the culture in the company and the front office. To discharge their personal responsibility, the senior manager will need to receive the right information from the business. This is likely to include monitoring of whether best execution is being achieved, but also whether processes are being followed and whether exceptions indicate that individuals are not executing trades as expected.

In addition to the senior manager responsible for best execution, a governance forum is also likely to have an oversight role. The forum will need to be at an appropriate level in the organisation so it receives sufficiently detailed information to monitor best execution. It will also need to have members with sufficient knowledge and expertise to provide effective challenge to manage the risks to achieving best execution. Reporting and escalation from the governance forum should feed into the senior manager's view of whether best execution arrangements are working as they should.

Second- and third-line reviews also have important roles to play. These functions should be checking whether best execution is being achieved, whether the policies, procedures, controls and oversight are effective, and whether they remain in line with regulatory expectations. The responsibilities for second- and third-line functions will sit with other senior managers, maintaining the important segregation of duties between the first, second and third lines of defence. Work done by the second and third lines needs to be mapped to the senior managers responsible for the areas reviewed so reports can be delivered to the appropriate individuals. The reporting will allow a senior manager to ensure any issues are appropriately addressed, and support them in discharging their responsibilities.

Taking the opportunity to step back

It is often difficult to step back and review the effectiveness of arrangements that have been in place for some time. The SM&CR provides an opportunity to take the time to carefully review how your business makes decisions, oversees delegation and drives behaviours. All these tie together to produce the outcomes you deliver to the investors in your funds. It is these outcomes that the regulator is interested in, and for which it will hold senior managers accountable.

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PricewaterhouseCoopers LLP

[1] FSMA or Financial Services and Markets Act.

[2] "New Accountability Regime for Banks and Insurers Comes into Force", Bank of England News Release, 7 March 2016.

[3] Best Execution and Payment for Order Flow, FCA Thematic Review TR 14/13, July 2014.

WILL THE DUTCH IMPLEMENT A BONUS CAP FOR AIFMS AND MANAGERS OF UCITS?

The Netherlands is famous for windmills, tulips and, well, far-reaching bonus caps for the financial sector. Where other EU Member States have implemented the bonus cap in accordance with the EU Capital Requirements Directive IV (CRD IV),[1] the Dutch have taken a broader approach with the Act on Remuneration Policies Financial Enterprises (ARPFE), which is part of the Dutch Financial Supervision Act,[2] and provides for a general bonus cap of 20% of fixed pay. That said, there are exceptions to the applicability of the 20% bonus cap that can be used in many cases. Unlike CRD IV, the ARPFE applies to a broader selection of firms than just banks and investment firms and the personnel scope is not limited to identified staff, but includes all staff. To date, AIFMs[3] and managers of UCITS[4] are exempt from the bonus cap, but the Dutch finance minister (and the chairman of the Euro Group[5]) Jeroen Dijsselbloem is in the process of drafting a bill that will also include certain AIFMs and managers of UCITS in the bonus cap. Whether the Draft Bill will also result in an actual bill is uncertain and will among others depend on how the Minister will respond on the comments made in the consultation process. In this article, we will set out the main rules of the Dutch bonus cap and look at the proposed bonus cap rules for certain AIFMs and managers of UCITS.

Current Dutch bonus cap rules

The ARPFE applies to financial enterprises (*financiële ondernemingen*) with their official seat in the Netherlands and their subsidiaries (including subsidiaries abroad). The definition of "financial enterprise" is very broad and includes banks, insurers, investment firms, payment services providers, custodians, premium pension institutions, AIFMs, and managers of UCITS, among others.

Similar to CRD IV, the ARPFE has a group-wide scope and is applicable to the whole group of companies (including those that are not financial) if:

- There is at least one financial enterprise with its official seat in the Netherlands within the group.
- And the ultimate parent company of the group (which does not have to be a financial enterprise) has its official seat in the Netherlands.

The central point of the ARPFE is the 20% bonus cap: a financial enterprise cannot pay any person "working under its responsibility" variable pay that exceeds 20% of the fixed pay on an annual basis. The annual fixed pay set out in the annual income statement (jaaropgave) – whereby (fixed) pension contributions are explicitly excluded – forms the basis for the bonus cap. Consequently, even though certain emoluments may qualify as fixed pay, such as regular pension contributions, these may not be taken into account when determining the basis for the maximum bonus. It goes without saying that this restrictive interpretation further decreases the actual maximum bonus amount.

The 20% bonus applies to any person working under the responsibility of the financial enterprise. However, a number of exceptions apply, as we list below.

- An average 20% collective bonus cap for staff in the Netherlands whose employment conditions are not exclusively covered by a collective labour agreement. The 20% cap does not apply on an individual basis, but to the average bonus of such staff collectively, provided that individually a 100% bonus cap applies.

- A 100% bonus cap for staff predominantly (at least 50% of their time) physically working outside the Netherlands but within the EEA.
- A 200% bonus cap for staff predominantly (at least 50% of their time) physically working outside the EEA, subject to shareholder approval and the procedure as determined in CRD IV.
- A 100% bonus cap for staff of a Dutch ultimate parent company only (thus not its subsidiaries) if at least 75% of all staff within the group of companies has predominantly worked outside the Netherlands during at least three out of the last five consecutive years.
- The bonus cap also applies to branch offices in the Netherlands of financial enterprises with their official seat in another state. Branches of banks and investment firms, with their official seat in another EU Member State, however, are excluded. For these branches, the CRD IV bonus cap of the EU Member State where such company has its official seat applies.
- No bonus cap applies to AIFMs, managers of UCITS and of investment firms trading solely and exclusively for their own account with their own funds and capital and that do not have external clients and that are a local undertaking (proprietary trading investment institutions). This exception also applies in the event the aforementioned managers are part of a group of companies that has to apply the Act on a group-wide basis. In the event an AIFM, or the manager of UCITS, is also allowed to perform certain MiFID activities under the relevant AIFMD or UCITS Directive licence, this exception also applies to such MiFID activities (i.e. individual investment management and investment advice).[6]

Proposal on extending the bonus cap to AIFMs and managers of UCITS

Over the summer period, the Dutch finance minister submitted the draft Financial Markets (Amendment) Bill 2018 (Draft Bill) for consultation,

which closed in September.[7] The Draft Bill proposes to amend the ARPFE to apply the CRD IV bonus cap (100% to 200% of fixed pay) for AIFMs, managers of UCITS and proprietary trading investment institutions that are part of a consolidated group (e.g. banks, investment firms, payment institutions and electronic money institutions, insurers and financial conglomerates). These AIFMs, managers of UCITS and proprietary trading investment institutions would no longer benefit from the exemption of the bonus cap referred to above and, consequently, would fully be caught by the bonus cap rules.

The Draft Bill relates to the European Banking Authority Guidelines on Sound Remuneration Policies (EBA Guidelines) that were published in 21 December 2015 and came into effect on 1 January 2017.[8] According to these EBA Guidelines, identified staff of the AIFM or the manager of the UCITS who also have a material impact on the CRD IV consolidation group's profile to which the AIFM or manager of UCITS belongs shall fall within the scope of the EBA Guidelines and therefore the CRD IV bonus cap applies.

Commentary on the proposal

The Draft Bill will have a more significant impact than foreseen by the EBA Guidelines, as we illustrate below.

- **Increased personnel scope**
  In practice, there will be only a very limited number of staff of an AIFM or a manager of the UCITS who meet the quality referred to in the EBA Guidelines (e.g. a director who is both a director of the AIFM or the manager of the UCITS and of the parent company of the CRD IV consolidation group).[9] However, the Draft Bill does not make a distinction between identified staff and regular staff. As a result, the bonus cap will apply to all staff working under the responsibility of an AIFM or manager of UCITS of a consolidation group referred to below (under the Draft Bill).[10]
- **Wider definition of consolidation group**
  As far as the relevant consolidation group is concerned, the Draft Bill goes beyond the EBA Guidelines. Where the EBA Guidelines are limited to AIFMs or managers of UCITS belonging to a consolidation group of a

CRD IV bank or investment firm, the Draft Bill includes consolidation groups of banks, investment firms, payment institutions, electronic money institutions, insurers, reinsurers, life insurers and non-life insurers and financial conglomerates.[11] Consequently, AIFMs and managers of UCITS that belong to these types of consolidation groups will all be caught by the bonus cap.

- **Bonus cap of 100% instead of 200% pursuant to the EBA Guidelines**
  Pursuant to CRD IV, in practice a bonus cap of 100% of the fixed pay applies, which can be increased to 200% of the fixed pay, provided that the shareholders agree to such an increase, in accordance with a procedure prescribed in CRD IV. The Draft Bill adds an additional requirement to this, which renders the possibility of a bonus cap to 200% for staff of the AIFM or the manager of the UCITS, working in either the Netherlands or other EU Member States, academic. This is because pursuant to the Draft Bill, the increase of the bonus cap from 100% to 200% only applies to staff of the AIFM or the manager of the UCITS who primarily perform their work in a non-EU Member State.

We believe that the increased scope of the bonus cap, which goes beyond the EU standard, is inconsistent with the principle of harmonisation of EU directives and regulations. The principle of harmonisation was the reason for the Dutch finance minister not to apply the bonus cap to AIFMs or managers of UCITS when the ARPFE was introduced in 2015, but to exempt AIFMs and managers of UCITS from the bonus cap. The Draft Bill is completely adverse to that approach of barely two years ago.

Furthermore, the Draft Bill will also upset the level playing field. The level playing field is already disrupted by CRD IV/the EBA Guidelines, as a bonus cap of 100% to 200% of fixed pay is introduced for AIFMs and managers of UCITS part of a CRD IV consolidation group. Other AIFMs and managers of UCITS (not part of any consolidation group) continue to be fully exempted from the bonus cap. The Draft Bill increases this difference still further: the scope of application is much greater (through an expansion to all persons working for the AIFM or manager of the UCITS and an increase of the relevant consolidation groups pursuant to the Dutch Financial Supervision Act), and the 200% bonus cap only applies to persons working outside the EU.

Next steps

The Draft Bill was submitted for consultation by market parties. The consultation process ended on 8 September 2016. Given the extensive number of comments from market parties on the minister's proposal to include certain AIFMs and managers of UCITS in the bonus cap, it is uncertain whether the Minister will include that part of the proposed bill in an actual bill that will be submitted to parliament. The fact that there will be general elections in March this year, further adds to that uncertainty.

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[1] Art. 94(1)(g) CRD IV.

[2] Art. 1:111 – 1:129 Dutch Financial Supervision Act.

[3] Alternative Investment Fund Managers.

[4] Undertakings for Collective Investments in Transferable Securities.

[5] Eurogroup: an informal body that brings together ministers from the euro area countries to discuss matters related to the euro, but see http://www.consilium.europa.eu/en/council-eu/eurogroup/, last accessed on 10 November 2016.

[6] See AIFMD, Art. 6: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN; see UCITSD, Art. 5: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0065&from=EN. Links last accessed on 1 December 2016.

[7] See https://www.internetconsultatie.nl/wijzigingswetfm2018, last accessed on 1 December 2016.

[8] See https://www.eba.europa.eu/-/eba-publishes-final-guidelines-on-sound-remuneration-policies-and-its-opinion-on-the-application-of-proportionality, last accessed on 26 October 2016.

[9] EBA Guidelines, art. 68, https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b, last accessed on 1 December 2016.

[10] The Draft Bill refers to a consolidation group referred to in part 3.6.2 (banks, investment firms, payment institutions and electronic money institutions, part 3.6.3 (insurers, reinsurers, life insurers and non-life insurers) and 3.6.4 (financial conglomerates) of the Dutch Financial Supervision Act.

[11] See footnote 10.

COMPANY LAW REFORM: WHAT ARE THE OPPORTUNITIES FOR INVESTMENT FUNDS?

On 23 August 2016, one of the most important legal bills for the investment funds industry at large, the reform of Luxembourg Company Law (Company Law Reform), entered into force and is now fully applicable.[1] What prospects does it hold for investment fund participants?

After 10 years of preparation, discussions, research and debate covering almost 1,000 pages and amending some 130 articles, the reform finally saw the light of day on the 101st birthday of the original act (also referred to as the 1915 Law).[2]

It is not only its date of entry into force that is symbolic. The Company Law Reform is the first major overhaul of the 1915 Law since the original version. While previous amendments to the 1915 Law focused mainly on the transposition of EU directives, the legislature have on this occasion chosen to go back to the very origins of the 1915 Law. The ultimate purpose of this reform was to modernise the Company Law in order to provide a modern and coherent legislative framework that would combine contractual freedom in the structuring of participations and governance models with a certain level of protection, and therefore offer legal certainty to those dealing with companies.

This is the first major overhaul of the Company Law since the adoption of fund specific legislation and is very good news for the investment funds industry.[3] Indeed many Luxembourg investment funds (UCITS and AIFs alike) have been established in corporate form, and Luxembourg holdings and special purpose companies, joint venture arrangements and other corporate structures have become some of the most recognisable European legal and corporate structuring solutions, including well beyond the borders of the EU Member States.

With the main goal in mind of creating bespoke investment opportunities and making the Luxembourg financial sector more competitive, the Company Law Reform offers more flexibility in structuring Luxembourg companies and partnerships alike and is an important tool in maintaining the attractiveness of the Luxembourg financial and investment funds centre.

Key areas of modernisation

The amendments made to the Company Law Reform cover all types of companies and partnerships. With regard to investment funds, the reform offers substantial benefits for the investment funds industry in two key areas…

In addition to the opportunities for structuring shareholders' participations and the governance of the public limited liability company (*société anonyme* or SA), which would benefit the investment fund industry at large and which are described in more detail below, the Company Law Reform makes two important improvements to the Luxembourg legal toolbox available for the structuring of alternative investment funds (AIFs) and their investments.

Firstly, the Company Law Reform completely overhauls the Luxembourg private limited liability company (*société à responsabilité limitée* or SARL) – the most commonly used corporate legal form in Luxembourg for the structuring of international private equity and real-estate transactions – bringing it closer to the regime applicable to the SA and make it more flexible. It confirms the use of the "redeemable" share concept, the optional softening of its transfer restrictions, the institution of the management board, the introduction of founder shares (*parts bénéficiaires*) with voting rights, the suspension or waiver of voting rights and the "authorised share capital" concept and also confirms that a SARL may publicly issue debt instruments, just to mention a few of the new key features.

Secondly, the Company Law Reform introduces a new legal form for the simplified limited company (*société par actions simplifiée* or SAS) that will substantially enhance governance structuring flexibility at manager and shareholder levels when compared with the ordinary limited company form. This new legal form will be available for the implementation of non-regulated AIFs in particular.

Structuring flexibility and legal certainty combined

The Company Law Reform offers new opportunities in the structuring of shareholders' participations. It legalises voting agreements and/or unilateral undertakings in the exercise of voting rights which may prove useful in the structuring of coinvestment arrangements. It also legalises the use of tracking shares that have long been used in practice with no express legal basis.

Non-voting shares

A noteworthy development for the investment funds industry is the possibility of issuing shares of unequal value with limited voting rights. The rules on the issue of non-voting shares have also been substantially relaxed. The latter development, in particular, offers new opportunities for the investment funds industry. On the one hand, it might prove interesting for fund initiators (AIFs and to a lesser extent UCITS) wishing to retain control over the structure. On the other hand, the non-voting shares could be issued for the benefit and on the request of investors not wishing to be seen to be acquiring control for consolidation or reporting purposes.

Why so? Although the possibility of issuing non-voting shares was introduced into the 1915 Law in 1983, the conditions applicable thereto, such as the fact that non-voting shares could not represent more than half of the share capital of the company and preferential dividend rights as well as voting rights on a number of matters, have been considered to be too restrictive for certain companies and an obstacle to the free organisation of their governance.

The Company Law Reform eases the restrictions and conditions applicable to the issuance of non-voting shares. In particular, there is no limit to the maximum number of such non-voting shares fixed by law. It is left up to the general meeting of shareholders to fix such number. This means that in practice all shares but one may be non-voting shares. The conditions for the issue of non-voting shares, in particular the economic rights attached to such shares, although freely determinable, must be laid down in the articles of association. The circumstances in which non-voting shares must bear the right to vote are limited to cases of the dissolution of the company, reduction of its share capital and amendments of the rights attached to such shares.

Transfers

Another interesting development for the investment funds industry as a whole is the new rules on the transfer of shares, according to which any transfer of shares of the company made in breach of the restrictions set forth in the articles of association of the company would be void.

This development brings legal certainty and is useful for funds that need to control the eligibility of their investors, e.g. where the fund is restricted to well-informed investors or limits the access of US persons.

The new provisions would bring reassurance to the management bodies of the funds that are vested, in accordance with the fund specific legislation, with an obligation to ensure the eligibility of investors and are ultimately liable for the breach of law. It would permit the directors of the fund to ignore the transfer made in breach of the restrictions of the articles of association and consider the transferor to be a shareholder.

Governance: solutions and more options

As a second pillar of modernisation, the Company Law Reform touches on the governance feature applicable to the SA, a legal form that can be used for the formation of UCITS and AIFs as well as their management companies or AIFMs.

It provides for real flexibility in structuring management arrangements. All types of management setup, be they individual or collegial, are permitted. In addition, the law provides a legal basis for various delegation models of management powers, e.g. the use of a management committee and the concept of "general manager" have now been included in the law.

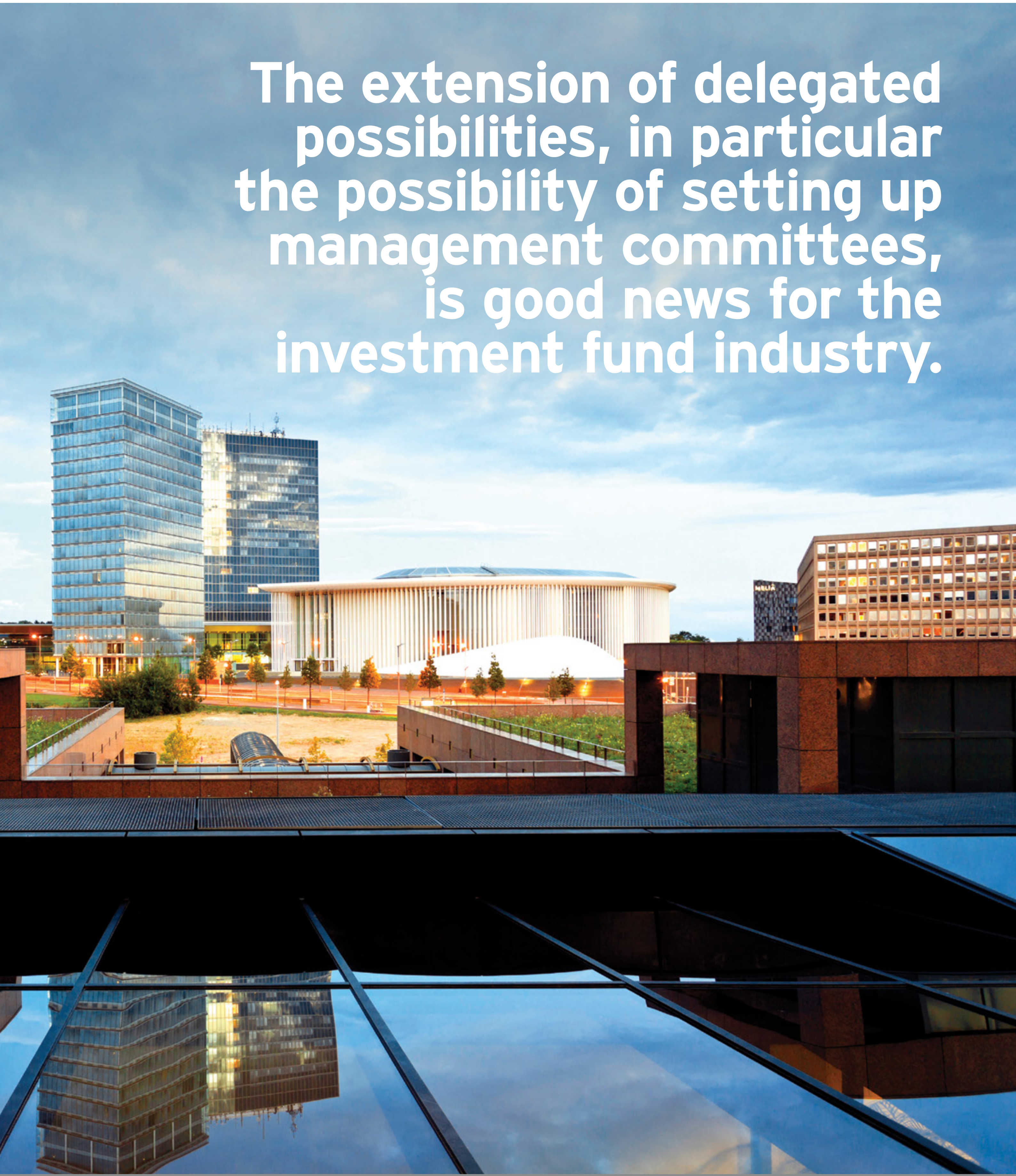
Management committee

The extension of delegation possibilities, in particular the possibility of setting up management committees, is good news for the investment fund industry. Indeed, the Company Law Reform seems to fill in the gap that existed between corporate law and the concept of management committee as it is known in the fund-specific legislation, which provides that management companies or AIFMs must be managed by at least two conducting officers who together form the management committee. Under the fund-specific legislation, such management committee is vested with an autonomous power of initiative, decision and control similar to that of a board of directors.

Under the Company Law Reform, the articles of association may authorise the board of directors to delegate its management powers to a management committee. Such management committee will be considered to be a corporate body of the company. It will be vested with the broadest powers of management, subject to general policy matters of the company and all the acts reserved to the board of directors by virtue of other provisions of the law. Where a management committee is instituted, the board of directors will assume the supervisory role. The members of the management committee will be subject to the liability regime applicable to directors for management faults and breaches of the articles.

Up to now, the question of the position of conducting officers under the 1915 Law was not clear. Formalising the management committee's appointment under the 1915 Law by appointing conducting officers as delegates for the daily management was a first option. While such appointment gave the delegate the power to represent the company in dealings with third parties in all actions included in this management concept without the need for a general or special power of attorney, it did, however, raise certain difficulties from the regulatory standpoint in respect of the compatibility of the concept of daily management with the functions of conducting persons. The concept of daily management, as defined in Luxembourg case law, is linked to the mere execution of the line of conduct set out by the board, without any real power of own initiative as the decisions that they must take are only the "result and the consequence of decisions taken earlier

The extension of delegated possibilities, in particular the possibility of setting up management committees, is good news for the investment fund industry.



by the board of directors".[4] The powers of conducting officers under the fund-specific legislation seem to go beyond the limits of the concept of daily management.

Alternatives to such delegation of daily management, i.e. the appointment of conducting officers as directors or agents of the company or its board of directors, did not constitute viable options either. The former due to potential conflicts of interest and thus incompatibility with regulatory standards, the latter due to its impracticality in dealings with third parties. Moreover, both alternatives created more risks for the board of directors, which could be held ultimately liable for the errors or negligence committed by the conducting officers as directors or agents.

The Company Law Reform should fill in the gap that existed between company law and fund-specific legislation. The management committee under the Company Law Reform seems to be fully in line with the regulatory concept.

Luxembourg management companies and AIFMs would now have an option – or, depending on the view of the Luxembourg Commission de Surveillance du Secteur Financier (CSSF) of this issue, an obligation – to establish management committees.

The conditions under which members of the management committee may be appointed, dismissed, remunerated and may carry out their duties, as well as the mode of operation of the management committee, shall be set out in the articles of association or, in the absence of any provision in the articles of association, by the board of directors.

Similarly, the articles of association may confer representation of the power on one or more members of the management committee, acting alone or jointly.

Now that the regulatory concept has found its equivalent in corporate law, it would be interesting to see whether the CSSF could systematically require management committees to be set up for each management company or AIFM.

Management by legal entities
Legal entities are not barred from managing Luxembourg companies. In this respect, the Company Law Reform provides important clarification.

It establishes that a legal entity may assume a management position in all management setups: as a director, general manager, member of the management committee, member of the management board (*directoire*) or supervisory board (*conseil de surveillance*). In such case, the legal entity must appoint a natural person as a permanent representative in charge of the execution of the functions in the name and for the account of a legal entity. The same applies to the appointment of a legal entity as liquidator. The rules applicable to SAs will also apply to SASs.

With regard to the corporate partnership limited by shares (*société en commandite par actions* or SCA), the Company Law Reform contains an important exemption to the above rule. Indeed, when legal entities are appointed as general partners of an SCA, the latter are not required to appoint a permanent representative. This clarification is made to prevent previous Luxembourg court rulings to the contrary from becoming precedent.

New "simplified" convening procedures
The opportunities for the fund industry are not limited to the managing bodies of companies.

The Company Law Reform harmonises and simplifies the procedures for convening general meetings of shareholders and the deadlines applicable thereto. It standardises the deadline for the publication of convening notices, fixing it at 15 days prior to the relevant general meeting. It establishes that the convening notices need not be published on the *Recueil Electronique des Sociétés et Associations* (RESA) where all shares are issued in registered form only. In addition, it provides that the holders of registered shares may be convened to the general meetings by means other than registered mail to the extent that such alternatives are provided for in the articles of association and accepted by shareholders on an individual basis.

Balance

It is natural that the reform is not one-sided. Luxembourg lawmakers have recognised that a sound legal system requires a fair and subtle balance between the interests of its stakeholders.

In exchange for increased flexibility and structuring opportunities, the Company Law Reform strengthens the protection of minority shareholders through increased transparency, and new rights have been added to the toolbox for shareholder protection, e.g. the right to pose written questions or initiate expert investigations. While the majority principle has prevailed in the 1915 Law to avoid blocking situations and ensure the continuity of a company's business, minority shareholder protection will henceforth be strengthened by the introduction of the minority social action (*action sociale minoritaire*), i.e. the right to initiate an action against the management (directors, members of the management or supervisory board) by shareholders holding 10% of the voting rights of the company.

Additionally, holding 10% of the voting rights becomes the uniform threshold for triggering shareholders' rights, be it for convening the general meeting of shareholders, the prorogation of the general meeting or the initiation of a minority shareholder action.

It would be interesting to observe how these new rights might be exercised by the minority shareholders in practice. This may change not only the climate of general meetings but also, through the minority shareholder action, increase the risk of directors being sued.

All in all, the Company Law Reform provides plenty of opportunities for structuring the shareholding and governance of the companies while at the same time offering stability over the long term.

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[1] See http://eli.legilux.public.lu/eli/etat/leg/loi/2016/08/10/n1 French version, last accessed on 22 November 2016.

[2] See http://eli.legilux.public.lu/eli/etat/leg/loi/1915/08/10/n1 French version, last accessed on 22 November 2016.

[3] For the purposes of this article, the term "fund-specific legislation" shall have the broadest meaning and be understood to comprise the rules applicable to the manager in addition to product rules.

[4] Luxembourg Court of Appeal, 18 March 1993, R. no 13501.

SHOULD ENFORCEMENT BE SEPARATED FROM THE UK'S FINANCIAL REGULATORS?

In July 2016, the Treasury Select Committee (TSC) published a review of the various reports into the collapse of HBOS plc (HBOS). One of its recommendations was to revisit the question of regulatory enforcement, specifically to consider whether the enforcement function should sit within the regulator or outside it as a separate body. Below, we take a look at what this approach means.

Regulatory change

The global financial crisis was the engine of a vast amount of regulatory change. Regulation was perceived to have failed and wave after wave of changes to conduct (behavioural) and prudential regulation have broken across the industry. The hope, it now seems, was that these changes would prevent a future crisis. However, in an industry that can only manage, rather than eliminate, risk, it remains to be seen whether that hope can be realised.

Along with conduct and prudential changes, many countries have engaged in structural regulatory change. For example, in the US,

the Consumer Financial Protection Bureau was created in 2008 to protect consumers, while in the UK, the former single regulator, the Financial Services Authority, has been broken into separate regulators – the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) – with the aim of sharpening the minds of each regulatory body to ensure that both prudential and conduct forms of regulation would receive sufficient attention.

The review of reviews into HBOS

There may be yet more structural change to come in the UK. The TSC's July paper, Review of the Reports into the Failure of HBOS, amounted to a literature review of the various reports already published on HBOS's collapse, though the TSC did take some new evidence of its own.[1]

The TSC pointed to earlier concerns about the coordination between the supervision and the enforcement functions inside what was then the FSA. HM Treasury (HMT) undertook a review into enforcement in December 2014[2] that "accepted that there was the potential for a degree of tension between the two functions". However, HMT "argued that cooperation between supervision and enforcement was likely to be 'imperilled', not improved, by separation".

The regulators at the time said that they supported the HMT's conclusions that enforcement and supervision functions should continue within the regulatory bodies themselves. Sir Brian Pomeroy, then a non-executive director at the FCA, was quoted as saying that there was a trade-off between "coordination, a free exchange of information and independence".

The TSC concluded that the question of enforcement separation should be looked at again. Three reasons were put forward for this:

The collapse of HBOS was a prudential failing. Yet, the bulk of enforcement staff sits within the FCA. An independent enforcement function "could and should sit equidistant between the PRA and the FCA".

A separate body would "bolster the perception of the enforcement function's independence". The current system, in which the same organisation supervises, applies and prosecutes the law, "is outdated and can be construed as unfair". Separation could "increase confidence in the impartiality of regulatory enforcement decisions, and facilitate objective scrutiny of supervisors' actions by enforcement staff".

Separation would allow the FCA, the PRA and the enforcement body itself to be clearer about their objectives. Better accountability and outcomes would follow.

The TSC said that it expected HMT to "appoint an independent reviewer to re-examine the case for a separate enforcement body".

The TSC agreed with the finding of Andrew Green QC in his HBOS report [3] that the regulatory regime in place at the time of HBOS's collapse did not encourage ambitious enforcement action. The TSC said, "In order to be a credible last line of defence, there must be a perception that regulators are able to undertake even the most challenging and complex of cases".

Parliamentary Commission on Banking Standards (PCBS)

Importantly, the TSC's concern over the perceived failures in enforcement stem from the failure of the regulators to take more senior bankers to task as a result of the global financial crisis. The PCBS report, *Changing Banking for Good*, published in 2013, was also concerned with the perceived lack of regulatory action against bankers.[4]

The PCBS did not go so far as to recommend a complete separation of the enforcement function from the regulators, saying that "to propose this change now would involve a new organisational upheaval for the financial services regulators, almost immediately after a major set of organisational changes have come into effect".

Decisions to invoke enforcement powers are taken inside the FCA by the Regulatory Decisions Committee (RDC). The PCBS said that the RDC "is not best-suited to the specific enforcement needs of the banking sector". The PCBS recommended "the creation of an autonomous body to assume the decision-making role of the Regulatory Decisions Committee for enforcement in relation to the banking sector".

Winning the Global Race

In 2015, the British Bankers Association (BBA) published *Winning the Global Race*, drawing on the consultancy services of Oliver Wyman.[5] This report was concerned with the competitiveness of the UK as an international centre and aimed at "developing a strategy to safeguard the position of the UK as a leading international banking centre, hosting foreign banks and UK-headquartered wholesale banks".

Sir Hector Sants, formerly the CEO of the FSA, was one of the Oliver Wyman consultants who worked on the report. His involvement inevitably created headlines when the report was published.

The BBA said in its report: [6]

> The current remit of regulators covers supervision, penalty and redress. This can distort incentives and create the potential for regulatory moral hazard and political influence. Many contributors believed that an independent body responsible for redress would result in better outcomes, not only for banks but also for their customers in ensuring rigorous alignment of redress amounts with the cost of any misdeed.

Among its twenty-three recommendations, the BBA also recommended that the government should "consider the creation of a new independent body responsible for penalty and redress decision-making".

Fairness for banks and bankers

Perhaps unsurprisingly, the BBA's concern is not with the number of senior bankers disciplined, but rather with the political pressures placed on regulators that can lead to unfair outcomes for banks and their staff.

The condemnation of bankers and banking has been something of an international sport for the last few years, but it is important that standards of fairness apply universally. Banks and bankers have the same right as anyone else to expect a fair application of the law.

The existing regime

In order to understand whether the existing regime should be changed, it is necessary first to understand what it is. The following description draws on the PCBS's report. The FCA's processes may have changed somewhat in the meantime, but are believed to be broadly similar.

As mentioned above, the body within the FCA that makes enforcement decisions is the RDC. However, before a case can be considered by the RDC, it must first be referred by Supervision and considered by Enforcement. Inevitably, some cases referred to Enforcement may be rejected before reaching the RDC, but Enforcement staff work together with staff from the referring department to reach an initial decision. If the matter proceeds further, investigators are appointed and scoping discussions held with the firm or individual.

At the end of the investigation stage, a report is sent to the person under investigation. If Enforcement wishes to proceed, the matter is sent to the RDC.

The RDC members are not members of the FCA's staff, and they and their secretariat are kept as separate as possible from the rest of the FCA. In particular, the RDC has its own lawyers, thus avoiding the need for the RDC to take legal advice from lawyers working in Enforcement.

This description of the process therefore does provide some comfort that proper attention is given to the existence and management of conflicts of interest that might influence the fairness of enforcement decision-making.

Does the existing process work effectively?

It is difficult to decide conclusively whether the existing process works effectively without knowing more both about the cases that are referred internally and about those that are later discontinued, either through Enforcement's decision or the RDC's. Nevertheless, the regular procession of published Decision and Final Notices gives a reasonable idea of the outcomes of the process.

Most of the FCA's Final Notices set out in detailed terms a firm's, or increasingly an individual's, failings. However, it is the RDC that produces the Notice. The firm or individual being punished is given an opportunity to comment and to ask for changes to the text, but the document will inevitably show the RDC's side of the case more forcefully.

The Upper Tribunal

Another way of considering the effectiveness of Enforcement and the RDC is to consider the cases that are subsequently sent to the Upper Tribunal. Where a person disagrees with the FCA's findings, the case can be referred to the Tribunal, which hears the case again. So it is not correct to refer to the Tribunal as hearing appeals.

The RDC has had its decisions overturned in relatively few cases since the regulatory regime began in 2001. The first such case was in 2005 against Legal and General Assurance,[7] in which the regulator intended to levy a financial penalty of GBP1.1 million for alleged rules breaches in the selling of low-cost with-profits endowment mortgage policies. The case was about the firm's sales and compliance procedures and whether they caused systemic misselling.

The current remit of regulators covers supervision, penalty and redress, which can distort incentives and create the potential for regulatory moral hazard and political influence, according to the BBA.

The Tribunal said that there were procedural defects that would have caused or contributed to missales. However, the Tribunal did not accept the FSA's claims about the extent of the missales. The Tribunal said that the RDC was "in error in its approach to the misselling cases and reached conclusions not justified by the material before it". A financial penalty of GBP575,000 was later issued.

Two other important cases that are worth considering are those relating to Angela Burns and John Pottage.

Angela Burns [8]

The regulator's case against Angela Burns was that she had behaved improperly in her activities as a non-executive director. The Decision Notice proposed a financial penalty of GBP154,800, along with a prohibition order to prevent Burns from carrying on any function in relation to any regulated activity (an absolute prohibition). The Tribunal upheld or partly upheld four allegations against Burns but dismissed six of them. The Tribunal found that Burns was in breach of Statement of Principle 1 (integrity) and that she was not a fit and proper person to carry out the non-executive director (CF2) function.

Despite the findings of the Tribunal, the regulator continued to argue for the financial penalty of GBP154,800 and the absolute prohibition order. The Tribunal said:

> In our judgment the Authority did not make a realistic reassessment of the position in the light of the fact that six out of its ten allegations failed and, out of the four which succeeded, three were upheld to only a limited extent. We find the Authority's submissions to be unsatisfactory and unpersuasive in a number of respects . . . In the circumstances, we find ourselves in wholesale disagreement with the Authority's assessment of the level of seriousness of the proven breaches, and accordingly with the level of financial penalty arrived at by the Authority. Furthermore, the Authority's contention that it would be appropriate to prohibit Ms Burns from carrying out any function in relation to any regulated activity rests on a more negative view of her conduct than that taken by the Tribunal.

The Tribunal considered that the appropriate financial penalty was GBP20,000. A prohibition order was imposed, but it only prevented Burns from acting as a non-executive director.

At the time of writing, Burns is in the process of taking further legal action in her case.

John Pottage [9]

Pottage was the CEO of two subsidiaries of UBS. The FSA wanted to impose a financial penalty on him of GBP100,000 because it was alleged he had "failed to take reasonable steps to ensure that the business of the firm complied with the requirements of the regulatory system". The two UBS companies were separately fined GBP8 million for failing to prevent four employees posting unauthorised trading losses to customer accounts.

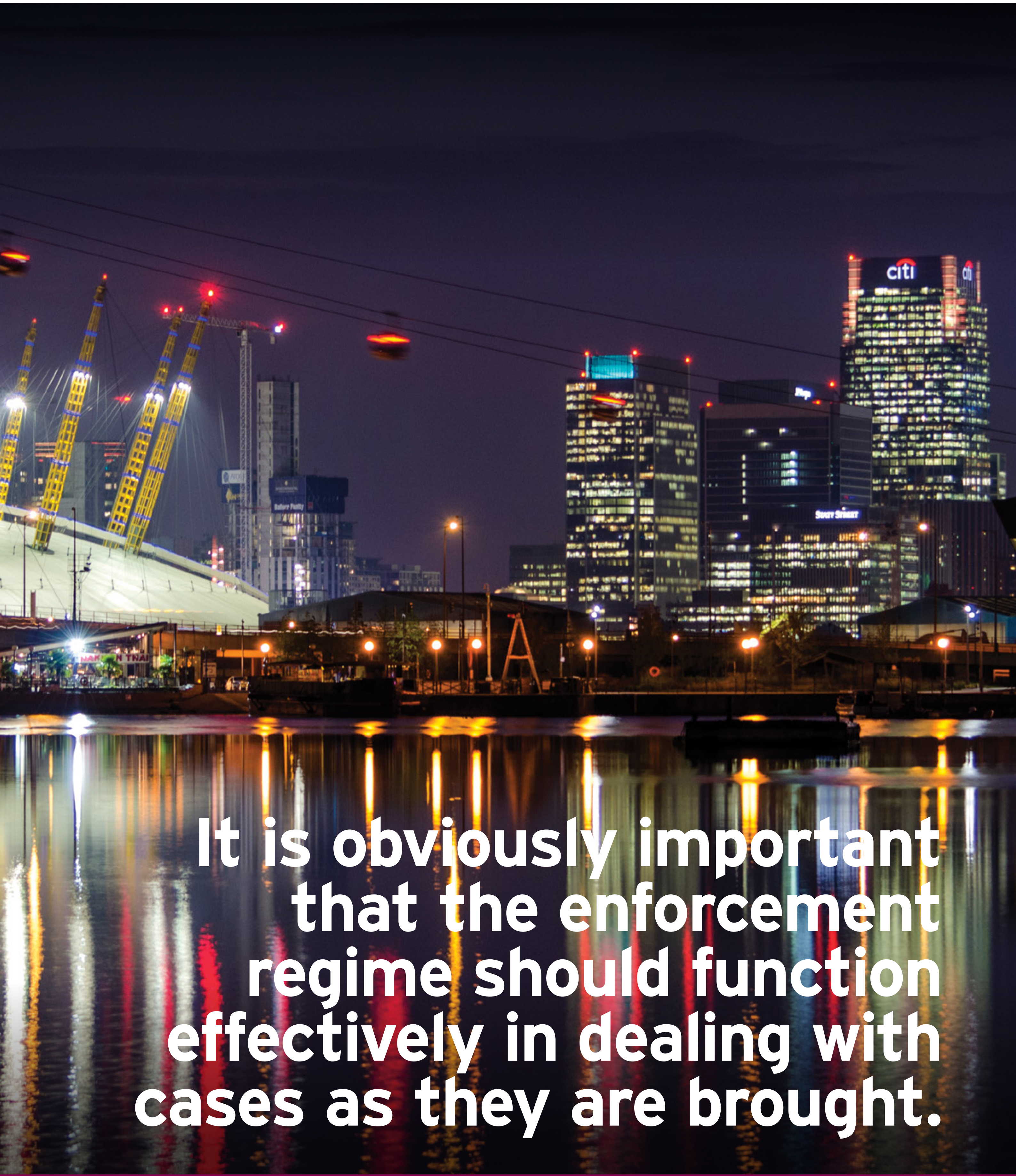
The case against Pottage related to the period when he first became the CEO and what he had done on his appointment. The FSA said he had failed to carry out an effective "initial assessment" of the business as would be expected of a new CEO. It also said he had not questioned effectively assurances that he was given by others, nor had he carried out continuous monitoring in particular to consider adequately the wider implications for governance and risk management of a series of warning signals. It was alleged he had also not begun early enough a systematic overhaul of the systems and controls in place in the business.

The Tribunal, however, considered the various activities that Pottage had done on appointment and concluded that they were the adequate actions of a new CEO, concluding, "The FSA has not satisfied us . . . from the evidence as a whole that Mr Pottage's standard of conduct was 'below that which would be reasonable in all the circumstances' (see APER 3.1.4G) . . . Put positively, we think that the actions that Mr Pottage in fact took prior to July 2007 to deal with the operational and compliance issues as they arose were reasonable steps".

Senior management liability and a separate enforcer

The TSC and the PCBS were concerned about the failure of the FSA enforcement regime to discipline bankers in the wake of the financial crisis and expect the system to generate more such cases in future. Indeed, the new senior manager regime is designed to make it easier for such persons to be targeted. The existence of statements of responsibility and responsibilities maps will enable regulators to work through the fog that frequently surrounds organisation charts in large corporate entities.

It is obviously important that the enforcement regime should function effectively in dealing with cases when they are brought



It is obviously important that the enforcement regime should function effectively in dealing with cases as they are brought.

forward. However, the belief that a separate enforcement body would produce more cases may be flawed. Whichever cases are ultimately taken to enforcement, they must first be referred to enforcement for consideration. At the moment, that can be done relatively easily. Such discussions with a separate enforcement body would likely be more formal in nature and may, as the PCBS feared, lead to fewer rather than more cases being referred.

Rights of the individual

A separate enforcement body would not necessarily generate more enforcement actions, but such a separation might be justified to safeguard the interests of individuals. Although, as noted, the regulator has not lost many cases in the Tribunal, those it has lost tend to concern individuals, and, of course, the increasing attention to personal liability means that there will probably be many more such cases in the future, facilitated by the new senior manager regimes. It is important for any regulatory disciplinary process to operate fairly, in the interests of both society and the individual.

A separate enforcement body would be more likely to take an arm's-length approach to discipline. Inevitably, such a body would not be perfect and referrals to the Tribunal would be expected to continue. However, on balance, the benefits of safeguarding individual rights seem to outweigh the efficiency that regulators enjoy in the regime as it operates at the moment.

HMT's response

On 10 October 2016, HMT responded to the TSC's HBOS recommendations.[10] It said the creation of a separate enforcement body was not merited. It said "There is a significant need for cooperation and coordination between supervisory and enforcement functions that are best served by combining these features in one organisation".

The TSC will doubtless respond further in due course.

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1 See http://www.publications.parliament.uk/pa/cm201617/cmselect/cmtreasy/582/582.pdf, last downloaded on 23 November 2016.

2 See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389063/enforcement_review_response_final.pdf, last downloaded on 23 November 2016.

3 See http://www.bankofengland.co.uk/pra/Documents/publications/reports/agreenreport.pdf, last downloaded on 23 November 2016.

4 See http:/www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/, last accessed on 23 November 2016.

5 See https://www.bba.org.uk/publication/bba-reports/winning-the-global-race-2/, last accessed on 23 November 2016.

6 *Winning the Global Race: The Competitiveness of the UK as a Centre for International Banking*, page 46.

7 See http://www.fsa.gov.uk/pubs/other/legal_general.pdf, last downloaded on 23 November 2016.

8 See http://taxandchancery_ut.decisions.tribunals.gov.uk/Documents/decisions/Burns-v-FCA-penalty.pdf, last downloaded on 23 November 2016.

9 See http://taxandchancery_ut.decisions.tribunals.gov.uk/Documents/decisions/John_Pottage_v_FSA_decision.pdf, last downloaded on 23 November 2016.

10 See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/558696/treasury_committee_response_HBOS_PRINT.pdf, last downloaded on 23 November 2016.

CATCHING UP ON A NEW KIND OF CORPORATE FUND IN SWEDEN

The final report of the Swedish government's 2014 Investment Funds Committee (2014 Committee) makes a number of suggestions concerning sustainability in fund management, fund management styles, investment rules for UCITS funds, ELTIF legislation and other matters including professional investors, capital requirements and – the subject of this article – a new kind of corporate fund. But before we catch up on this latest funds development in Sweden, a quick summary of what brought the market to this point is appropriate.

The road to a structure for investment funds

On 30 October 2014, the Swedish government appointed the 2014 Committee to propose legislation for the implementation of the UCITS V Directive and make proposals for the enhancement of the competitiveness of the Swedish investment funds market including, for example, additional types of funds for professional investors.[1]

The directives for the 2014 Committee – in part reflecting the interests of the minority coalition government between Social Democrats and Greens, the latter of whom provides the Financial Markets Minister – were extended on 18 December 2014 to include the review of sustainability issues in the investment funds market.[2] They were further extended on 19 March 2015 to address the distinction between passive and active fund management styles.[3]

On 5 November 2015, the deadline for the final report of the 2014 Committee was extended to 30 June 2016, after the delivery of an interim report on the implementation of UCITS V in June 2015.[4] The final report was duly submitted to the government in June 2016.[5]

That final report makes several suggestions for sustainability in fund management, active and passive fund management styles, certain clarifications to the investment rules for UCITS funds, legislation dealing with European Long-Term Investment Funds (ELTIFs) and certain other matters concerning professional investors, certain capital requirements and a new kind of corporate fund.

Historically, investment funds in Sweden have only come in the form of contractual funds, subject to a particular statutory regime (in various guises in 1974, 1990 and 2004). There has not been a corporate structure for investment funds. The need for corporate investment funds was discussed in an earlier committee report. However, it was then concluded that there was no need for the introduction of corporate funds in Swedish law.[6]

This conclusion, however, has now been reassessed, and the 2014 Committee has proposed that corporate funds be introduced in Swedish law through a new act, the Investment Companies Act (*lag om investeringsbolag*).

"Investment company" (*investeringsbolag*) is the term suggested for this new type of investment fund, which will sit alongside other types of pre-existing funds such as:

- Contractual UCITS funds (*värdepappersfonder*).
- Contractual funds granted exemptions from the UCITS rules, "special funds" (*specialfonder*) (for regulatory purposes, special funds are "alternative investment funds").

Below we explore what this new fund entails and how it will affect fund managers in the Swedish market.

A look at the investeringsbolag

This new type of fund was broadly based on similar fund structures in other jurisdictions, such as Luxembourg SICAVs, British OEICs and Irish ICAVs. The investment company will be structured in a way that appears to be a radical departure from the established principles of Swedish company law, in that it will have a variable share capital, though the proposals are actually less radical than they may seem.

The 2014 Committee has not fully taken notice of the implications of the implementation of the AIFMD in Sweden.[7] The AIFMD means that Swedish limited liability companies (*aktiebolag*) – without any adjustments to company law – are treated as "funds" for regulatory purposes. The share capital of limited liability companies are always fixed. However, by using various debt instruments as the means for investors to make investments (so-called fund units), it has been possible to set up – and get regulatory approval for – alternative investment funds organised as limited liability companies with, in effect, variable capital.[8]

The 2014 Committee explicitly intends the proposed rules on investment companies to be a test case, to be evaluated as to their practical impact.

The corporate alternative investment funds throw up a number of legal issues, such as the interrelationship between the role of the board of directors that a limited liability company necessarily has, even when it is categorised as an externally managed alternative investment fund. The contradictions that arise from this structure, e.g. the competition between the effective authority of the managers and that of the board of directors and the general meeting of shareholders of the alternative investment funds, have not been in any way addressed by legislation or regulation.[9] This includes the classification of the fund units that, for the purposes of civil law are debt instruments, under the AIFMD, and, prima facie, the fund units themselves, as they are debt instruments, may be thought to constitute "leverage"" for AIFMD purposes.

The new investment companies will, however, only be permitted for funds authorised as UCITS funds. Under the proposals, the regulatory category of UCITS funds would correspond to two alternative structures in civil law: either the traditional contractual form or the new form of an investment company. The current proposals do not envisage investment companies organised to function as alternative investment funds, except that exceptions to the UCITS regulations will be permitted on the same terms as for current special funds.

The statutory regime for investment companies is not, in the current proposals, entirely independent of general company law. Instead, investment companies will be subject to general company law (*aktiebolagslagen*), with certain specified adjustments. This model has already been used for credit institutions and insurance undertakings organised as corporations. Investment companies will be able to operate either as internally managed or externally managed funds.

For externally managed funds, adjustments are particularly called for to allow the manager effectively to take the position of the general meeting of shareholders and the board of directors in internally managed funds (and regular companies). Where an externally managed investment company retains a board of directors, the board may not intervene in the day-to-day running of the company but will be acting as a supervisory board overseeing the managerial discharge of its obligations.

Under the proposals, fund managers will be permitted to manage more than one investment company. Though the 2014 Committee discussed, but decided against, permitting umbrella funds in the form of investment companies, it did permit the use of more than one series of shares (each series differing in terms of voting rights, dividends, fees, minimum purchase price, distribution, currency hedging and the currency for purchases and redemptions). Investment companies will thus be permitted to operate as both feeder and master funds.

No share certificates may be issued; the shares will be dematerialised, either in the shareholders register kept by the manager or the internally managed investment company, or by a central securities depository (CSD). The share capital of an investment company is tantamount to the net value of the company's assets. The purchase price of a new share in the company should be an amount corresponding to the net asset value divided by the number of shares immediately prior to the issuance of the new share. On redemption, the shareholder receives an amount for each share corresponding to the net asset value divided by the number of shares immediately prior to the redemption.

An internally managed investment company must have a minimum capital of EUR300,000 in the form of subordinated loans. The minimum capital must be invested in liquid fixed income instruments (for instance, sovereign debt) or deposited with a credit institution. In an internally managed investment company, the owners have to be approved along the same lines as for an external manager. However, in calculating whether an owner has an interest that requires approval, only the votes — not the capital — will be taken into account.

The 2014 Committee explicitly intends the proposed rules on investment companies to be a test case, to be evaluated as to their practical impact. The 2014 Committee chose not to introduce investment companies for the purposes of alternative investments, but it did not rule that option out on principle. Instead, it suggests that any such extension of the scope of investment funds should be appraised in light of the practical experiences garnered from investment companies characterised as UCITS funds.

The reaction — public consultation responses

The proposals have been subjected to public consultations. The responses have been mixed. For instance, the Swedish Bar Association (*Sveriges Advokatsamfund*) welcomed the proposals in principle, but argued for the speedy extension of the investment company model also to alternative investment funds, in part to address the conflicts that arise between the regulation of the managers of alternative investment funds and corporation law. The association also raised some concerns about the differences between contractual funds

The great elephant in the room, however, is taxation.

and investment companies: for instance, that contractual funds cannot be subject to collective insolvency proceedings, which the proposals explicitly countenance for investment companies.[10]

The Swedish Private Equity & Venture Capital Association (SVCA) also embraced the proposals and urged that the investment company model be extended to include alternative investment funds, and that this be made in a flexible manner that would genuinely enhance the attractiveness of the Swedish funds market.[11]

The Swedish Bankers' Association (*Svenska Bankföreningen*) added its support to the proposals and stressed that care should be taken to ensure that investment companies, as a fund format, could hold their own in competition with other leading funds jurisdictions.[12]

The Swedish Investment Fund Assocation (*Fondbolagens Förening*) strongly endorsed the proposals for investment company rules. Although the association agreed that a piecemeal introduction of the new structure would be advantageous, it queried the arguments mooted by the 2014 Committee against umbrella funds.[13]

The Swedish Financial Supervisory Authority (*Finansinspektionen*) expressed cautious support for the idea of corporate investment funds, but it did not think the current proposals were sufficiently thought through to be made into law. In particular, the authority criticises the 2014 Committee for having paid insufficient attention to the AIFMD rules. Interestingly, the authority is concerned that some of the proposals may render investment companies insufficiently attractive, especially in the form of internally managed funds.[14]

The Central Bank (*Riksbanken*) is also cautiously optimistic, but it calls for further work on the proposed investment company legislation before the proposals are enacted, in particular in respect of initial capital and insolvency (echoing some of the Bar Association's concerns).

Given the mixed consultation results – in particular, perhaps, from the Swedish Financial Supervisory Authority and the Central Bank – it is unclear whether the proposed act on investment companies will be introduced, at least in the very near term and in the form of the proposals. However, there seems to have occurred a change in the consensus that corporate funds are indeed desirable in principle, and that they should not be limited to UCITS funds.

The great elephant in the room, however, is taxation. The 2014 Committee was not asked to look into the taxation of investment funds. Among market participants it is widely thought that, whatever reforms might be introduced in other respects, the real crunch as regards reviving the Swedish fund market is tax reform. However, there currently seems to be very little political appetite for that type of reform.

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1 See Dir. 2014:139.

2 See Dir. 2014:158.

3 See Dir. 2015:28.

4 See Dir. 2015:109 for deadline, and SOU 2015:62 for report.

5 See SOU 2016:45.

6 See SOU 2002:56.

7 Alternative Investment Fund Managers Directive.

8 See D. Hanqvist, Lagen om förvaltare av alternativa investeringsfonder. En kommentar, Wollters Kluwer (2016), p. 168 and 186.

9 See Hanqvist (2016), p. 284 et seq. and (especially in respect of liability issues) H. Tsikhanava, "Alternativa investeringsfonder och organs skadeståndsansvar – En regleringsteknisk röra?", Master of Law Dissertation, Spring Semester 2016, University of Stockholm Law Faculty.

10 See https://www.advokatsamfundet.se/globalassets/advokatsamfundet_sv/remissvar/571462_20161108165910.pdf, last downloaded on 1 December 2016.

11 See http://resources.mynewsdesk.com/image/upload/kwq6cn1hxi6k4p1gnpfq.pdf, last downloaded on 1 December 2016.

12 See http://www.swedishbankers.se/BFDokumentarkiv/Konkurrenskraftig%20fondmarknad.pdf, last downloaded on 1 December 2016.

13 See http://fondbolagen.se/sv/Juridik/Remissyttranden/2016/Dokument/Remissvar-avseende-betankandet-En-hallbar-transparent-och-konkurrenskraftig-fondmarknad-SOU-201645-Fi201602541V/, last accessed on 1 December 2016.

14 See http://fi.se/Regler/Remissvar/Svenska-forslag/Listan/Yttrande-over-slutbetankandet-En-hallbar-transparent-och-konkurrenskraftig-fondmarknad/, last accessed on 1 December 2016,

15 See http://www.riksbank.se/Documents/Remisser/2016/remiss_FiD_161107.pdf, last downloaded on 1 December 2016.

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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