Cross-border distribution of investment funds in Europe

The final texts of the EU cross-border distribution of collective investment undertakings legislative package were published in the Official Journal on 12 July 2019.

The Directive and Regulation (the “CBDF package”) were adopted by the Council in June 2019 and the Parliament in April 2019, and will enter into force on 1 August 2019. Member States are required to implement the Directive into national law by 2 August 2021. The Directive and Regulation were originally proposed by the EU Commission in March 2018 and have undergone a number of changes during the political process. Our note on the original proposals is available here.

Key provisions

> A new harmonised “pre-marketing” regime under AIFMD, which will be welcomed by many fund managers as an improvement on the current patchwork approach across Member States.

> Placement agents and distributors carrying out pre-marketing must be EU regulated firms or tied agents, and will be directly subject to the new AIFMD rules on pre-marketing.

> A new procedure for de-notification of marketing under both the UCITS Directive and AIFMD, including restrictions on pre-marketing successor funds.

> Similar standards of marketing communications for AIFs and UCITS to ensure they are consistent, and fair, clear and not misleading.

> Changes to information filed for AIF/UCITS marketing passports.

> Greater transparency and high-level principles for calculating regulatory fees.

> Changes to certain administrative requirements for retail investors.

> Signs that EU authorities are concentrating on reverse solicitation.

> Delay to PRIIPs KID application to UCITS.

The CBDF package is aimed at reducing regulatory barriers to cross-border distribution of collective investment undertakings in Europe, and apply to investment funds regulated by the Undertakings for Collective Investment in Transferable Securities (“UCITS”) Directive and the Alternative Investment Fund Managers Directive (“AIFMD”), which includes alternative investment funds (“AIFs”), European venture capital funds (“EuVECs”), European social entrepreneurship funds (“EuSEFs”) and European long-term investment funds (“ELTIFs”). The Directive and Regulation introduce measures to further harmonise and align the operation of the marketing regimes under both Directives, and directly amend the provisions of AIFMD and the UCITS Directive, as well as the EuVECA and EuSEF Regulations. Some well-publicised changes to the packaged retail and insurance-based investment products (“PRIIPs”) Regulation are also made.

Harmonised pre-marketing regime

One of the main criticisms of the existing AIFMD marketing framework has been the different interpretation of the term “marketing” across Member States. For example, the UK and Luxembourg interpret the marketing concept as applying at a relatively late stage, being when the offer of interests in an AIF is capable of being accepted by investors on final form subscription documents. Whereas in other countries AIFMD marketing activity is interpreted as taking place much earlier. This creates a catch-22 situation for fund managers as typically, before establishing and finalising the terms of a fund, they will want to pre-market in order to assess whether there is demand for the product, and will want to discuss and test some of the terms. However, it is impractical or impossible to approach investors to assess demand in a country that regards these initial discussions as “marketing” requiring the fund to be established and largely fully documented. The CBDF package seeks to address this issue by introducing a new harmonised pre-marketing regime into AIFMD. The EuVECA and EuSEF Regulations are similarly amended. As AIFMD is a text “with EEA relevance”, the references in this note to EU alternative investment fund managers (“AIFMs”) will cover EEA AIFMs. The pre-marketing rules come into force on 2 August 2021.
The Commission will also be required to report by 2 August 2023 on the merits of applying a similar pre-marketing regime to UCITS.

The new pre-marketing definition
The definition of “pre-marketing” itself is broad – it captures activity which involves:
“provision of information or communication, direct or indirect, on investment strategies or investment ideas by an EU AIFM or on its behalf, to potential professional investors domiciled or with a registered office in the Union in order to test their interest in an AIF or a compartment which is not yet established, or which is established, but not yet notified for marketing in accordance with Article 31 or 32, in that Member State where the potential investors are domiciled or have their registered office, and which in each case does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment”.

The pre-marketing parameters
A new Article 30a will be included in AIFMD setting out harmonised conditions for pre-marketing, which require that any information presented to potential professional investors by an EU AIFM must not: (i) be sufficient to allow them to commit to invest; (ii) amount to a subscription form or similar (in draft or final); or (iii) amount to final form constitutional documents, a prospectus or offering documents of a not-yet-established AIF. Importantly, and in a change to the original proposals, managers will be able to provide a draft prospectus or offering document to potential investors. However, this is with the proviso that it does not “contain information sufficient to allow investors to take an investment decision”. What that means in practice will need to be thought through and may depend on how the Directive is implemented in Member States. Draft documents will also need to be clear they are not an offer or invitation to subscribe, with a warning that information therein should not be relied upon because it is incomplete and may be subject to change.

Notification of pre-marketing
Pre-marketing activity will not need to be notified to competent authorities in advance, however AIFMs will need to send a letter to their local home state regulator within two weeks of beginning their pre-marketing. The letter will need to specify where and for which periods the pre-marketing is taking or has taken place, with a brief description of the pre-marketing (including information on the investment strategies presented and the AIF(s) covered). This may have some practical compliance challenges, particularly where pre-marketing is ongoing over a longer period, and potential investors are contacted through pre-marketing activity without first completing a draft prospectus or offering document to potential investors. However, this is with the proviso that it does not “contain information sufficient to allow investors to take an investment decision”. What that means in practice will need to be thought through and may depend on how the Directive is implemented in Member States. Draft documents will also need to be clear they are not an offer or invitation to subscribe, with a warning that information therein should not be relied upon because it is incomplete and may be subject to change.

Placement agents and distributors
Any third party carrying out pre-marketing on behalf of an AIFM will need to be authorised as an investment firm under the Markets in Financial Instruments Directive (“MiFID”), a credit institution, a UCITS management company or an AIFM, or act as a tied agent in accordance with MiFID. In addition, the agent will be directly subject to the pre-marketing rules in the Directive. This is a significant development. Placement agents and distributors will need to make sure they are prepared for this change, including getting any relevant authorisations or transferring functions to a locally licensed affiliate.

Marketing without a passport
Finally, it is worth noting that although the CBDF package only applies to pre-marketing of AIFs by authorised EU AIFMs, Member States are not completely free to continue their current interpretation of how the marketing rules apply to non-EU managers under Article 42 AIFMD (national private placement regimes). A recital to the Directive states that national rules cannot in any way disadvantage EU AIFMs vis-à-vis non-EU AIFMs.

Discontinuing marketing
For both the AIFMD and UCITS Directive passports, there will be a new formalised procedure for discontinuing marketing. Managers will be able to discontinue marketing a fund in a particular Member State provided that certain conditions are fulfilled and a denotification filing made with its home state regulator. These provisions come into force on 2 August 2021.

Conditions
The conditions are (i) making a blanket offer to repurchase or redeem units held by investors in that Member State (free of any charges or deductions) which is publicly available for at least 30 working days and is addressed individually to all investors in that Member State whose identity is known (this condition does not apply to closed-ended AIFs); (ii) publicising the intention to terminate marketing arrangements; and (iii) terminating or modifying any relevant contracts with financial intermediaries to ensure they do not continue to market those units. For a UCITS, items (i) and (ii) must be in the official language of the Member State where the UCITS has been marketed.

Restriction on pre-marketing successor funds (AIFs)
Once an AIF is denotified from marketing, the AIFM may not then engage in pre-marketing that AIF, nor another AIF with a similar investment strategy or investment idea, in that Member State for a period of 36 months from the date of denotification. Assuming a manager filed to denotify a closed-ended AIF at the end of its marketing period (often 12 to 18 months from first closing), pre-marketing a successor fund could not then commence for another 36 months, which in practice may well be beyond the end of the prior fund’s investment period. Clearly this is going to cause difficulties for managers who would want to be out in the market raising a successor fund much earlier, to prevent a time gap between investing prior and successor funds (and the corresponding impact on fee flows). Unless helpful regulatory guidance is given on this topic, in practice managers may simply choose not to deregister any funds, accepting the ongoing regulatory fees as a cost for pre-marketing a successor fund. This is an issue to watch out for both market practice and regulatory guidance.

Regulatory fees and charges
Another significant criticism of the existing marketing regimes relates to the, often large and ongoing, fees charged by competent authorities in Member States where a fund is being marketed. The Regulation therefore sets out that any fees or charges shall be “consistent with the overall cost relating to the performance of the functions of the competent authority”. This provision will come into force immediately on 1 August 2019, although whether this will prompt a reduction in fees is yet to be seen.

Also coming into force on 1 August 2019 is a requirement for competent authorities to publish a list of all fees or charges or, where applicable, relevant calculation methodologies, on their websites, however this will not need to be published until 2 February 2020. ESMA will then maintain a centralised collection of hyperlinks to those relevant pages on its website by 2 February 2022.

Marketing communications
Another notable change to current rules for funds under the AIFMD umbrella at least, is the application of similar standards of marketing communications to EU AIFMs and UCITS under the Regulation. These will come into force on 2 August 2021.
In particular, UCITS management companies, AIFMs, EuVECA managers and UCITS management companies must “ensure” that all marketing communications addressed to investors are identifiable as such, describe the risks and rewards of purchasing units or shares in an equally prominent manner, and that all information included in marketing communications is fair, clear and not misleading. Statements in marketing materials must not contradict or diminish the significance of information in other communications to investors – for UCITS the prospectus and key investor information, and for AIFs the Article 23 disclosures (and the corresponding provisions in the EuVECA and EuSEF Regulations). The similar provision currently in Article 77 of the UCITS Directive will be deleted as a result.

Marketing communications will also have to specify where, how, and in which language investors and potential investors can obtain a summary of investor rights, and shall provide a hyperlink to such a summary which must include, as appropriate, information on access to collective redress mechanisms at EU and national level in the event of litigation.

In order to verify compliance with marketing provisions, competent authorities will be able to require prior notification of marketing communications used by UCITS management companies, and by AIFMs, EuVECA managers and UCITSE managers where their funds are marketed to retail investors, however this requirement for prior notification does not amount to a prior condition for marketing. A competent authority will have 10 working days following receipt of notification to request that a manager amend its marketing communications. ESMA will report every other year on the number of requests for amendments made on this basis and decisions taken, describing the most frequent breaches. These provisions will come into force immediately on 1 August 2019.

Changes to fund information filed for marketing passport
Managers are required to notify the competent authority of their home Member State of material changes to information filed for the marketing passport, within specified timeframes depending on whether the change is planned or unplanned. From 2 August 2021, the timeframes competent authorities will have to respond change as follows:

AIFMD: The relevant timeframe would change from “without undue delay” to 15 working days to respond to the AIFM if the competent authority does not permit a planned change, and from “without delay” to one month to pass on the information to a host Member State if the changes are acceptable.

UCITS: The relevant timeframe is introduced as a new requirement. The UCITS will have to notify both its home and host competent authority at least one month before implementing any change. The home competent authority must respond to the UCITS within 15 working days if it does not permit a planned change.

Facilities for retail investors
The treatment of retail investors under both AIFMD and the UCITS Directives are further aligned, with new requirements for both AIFMs and UCITS to put in place certain “facilities” for each Member State in which they market to retail investors. ELTIFs are already subject to this requirement. The facilities would perform certain tasks, such as processing subscription, repurchase and redemption orders, and make other payments to unit-holders; and provide information about how to make such orders. They would also facilitate the handling of information relating to the exercise of investors’ rights, make fund information available for inspection, and act as a contact point for communicating with competent authorities. Such facilities would need to be able to perform tasks in the official language(s) of the relevant Member State or in a language approved by the competent authorities of that Member State, however Member States should not require these facilities to be provided via a physical presence. The facilities can be provided via a website, and may be performed by the AIFM/UCITS or by a third party. Whilst these rules are aimed at funds targeting retail investors, they could also capture interests in vehicles (eg co-investments) offered to fund executives falling within the retail investor definition. These requirements will come into force on 2 August 2021.

Transparency framework
From 2 August 2021, competent authorities will have to publish and maintain on their websites complete information on all national laws, regulations and administrative provisions governing marketing requirements for AIFs and UCITS, and summaries thereof. Competent authorities would have to notify such information to ESMA, which would in turn be required to maintain a central database of summaries of and links to all national provisions, by 2 February 2022.

By 2 February 2022, in addition to the central database it already maintains of AIFMs and UCITS management companies, ESMA will be required to publish on its website a central database of all AIFs and UCITS marketed in a Member State other than their home state, along with details of their relevant manager and a list of all the Member States in which they are marketed.

Commission report on reverse solicitation
In a sign that the EU authorities are concentrating on the use of reverse solicitation by some fund managers, the Commission will be required to report to the Parliament and Council by 2 August 2021 on “reverse solicitation and demand on the own initiative of an investor”, specifying the extent of that form of subscription to funds, its geographical distribution (including in third countries), and its impact on the passporting regime. The Commission will need to consult with competent authorities, ESMA and other relevant stakeholders for the basis of the report. As this information is not currently routinely gathered, this timeline may prove challenging.

Commission assessment of AIFMD passporting regime
A new Article 69a will be included in AIFMD to require the Commission to report to the Parliament and Council before any legislation is passed to extend the AIFMD passport to third countries. Such report will need to take into account the result of an assessment of the passport regime, including the extension of that regime to non-EU AIFMs. There is no calendar deadline for this report however, and it is in addition to the other reports which are already required on this topic, including the ESMA opinion and advice on the passport required by Article 67.

PRIIPs changes
Taking immediate effect on 1 August 2019, certain changes will be made to the PRIIPS Regulation to delay the application of a PRIIPS KID to UCITS until 31 December 2021, and to extend the deadline for Commission review of the PRIIPS Regulation to 31 December 2019.

Next steps
Member States will have to take steps to implement the Directive into national legislation by 2 August 2021. Many of the provisions in the Regulation will similarly come into effect on the same date, however certain provisions will apply immediately, albeit often with later deadlines as noted above.

For the UK, the provisions taking immediate effect will form part of the “EU acquis” brought across into UK law as at the date of a “no deal” Brexit, however the majority of the provisions coming into force in 2021 or later would depend on whether there is a transition deal or not as to how and whether it is implemented into UK law.
Key Contacts

If you would like to discuss these changes, or any aspects of AIFMD or the UCITS Directive, please contact your usual Linklaters LLP contact or anyone shown below.

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