

GREAT FUND INSIGHTS

New Year, New Regulation: As a funds/asset manager – what should I be thinking about for 2023?

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Welcome to this Allen & Overy podcast. My name is Hilaire Bedier and I'm an Associate in Allen & Overy's London Funds and Asset Management Group.

Today we are going to be talking about some of the key upcoming regulatory changes which asset managers and funds should have on their radar as we move towards 2023.

Joining me in this discussion today are Emma Danforth, who is a Partner in our London Funds and Asset Management Group, and Codrina Constantinescu, who is a Counsel in our Luxembourg Funds and Asset Management Group. Thank you both so much for joining.

So, Codrina, the hot topic at the moment seems to be the retailisation of Funds – could you start by explaining what people mean by this?

Codrina

Sure. As we all know, professional investors generally dominate the alternative funds space but retailisation is the opening up of the alternative funds space to retail investors.

Maybe just a quick reminder regarding the term “retail investor”. Under AIFMD, a retail investor is an investor that does not qualify as a professional investor. The tests to be a professional investor and for retail investors to opt up to being professional investors set quite a high bar for being a professional investor as this negative definition is very broad and captures a huge number of potential investors out there.

Hilaire

And so why is everyone talking about this at the moment?

Codrina

It's the combination of the developing appetite of retail investors for alternative strategies as well as the sheer number of potential investors in this largely untapped group. The European Long Term Investment Fund, also known as ELTIF, and the proposed amendments to the current ELTIF regimes are seen by many as a key development in enabling managers to tap into this part of the market.

To give a brief history of the ELTIF, it has been introduced in 2015 in response to industry demands for an investment vehicle suitable for long-term investment that was open to retail investors and the benefits of a pan-European marketing passport for such retail investors. Whilst there has been some uptake by managers – and some large asset managers used the ELTIF product for developing their retail market offering – uptake has been limited, with only 79 ELTIFs having been set up in the EU, with 43 of those set up in Luxembourg.

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- Hilaire** OK, so I suppose not the largest numbers at the moment, and what do you think the reason is for such a limited uptake?
- Codrina** The main reasons for this are the overly prescriptive investment rules, such as a borrowing limit of 30% for ELTIFs regardless of whether they are retail or non-retail ELTIFs, as well as the complex eligibility and marketing rules. The good news is that a reform of this product is now on the point of being finalised at EU level and this goes definitely in the right direction with remedying some of these barriers – it's fair to say that at the moment the entire fund industry is very excited about that. The new regime will enter into force in 2023.
- Hilaire** OK, so that sounds like a very exciting development. So you have spoken about these changes: how significant are the changes to the ELTIF rules and do you think that they are enough to enable ELTIFs to really open up the alternative space to retail investors?
- Codrina** First and foremost, the ELTIF reform introduces a real distinction between retail and the non-retail ELTIFs – and this basically removes a good number of the diversification restrictions for non-retail ELTIFs while making them better suited for professional investors. Also the reform adds great flexibility to the diversification restrictions for retail ELTIFs.
- In addition, certain of the more onerous marketing restrictions in relation to retail investors will now be waived; however, some requirements such as the MiFID suitability assessment for marketing to retail investors and the need to issue a PRIIPs KID will be retained in order to protect retail investors.
- Hilaire** OK, so I suppose they are making some things a bit easier and some things are staying. Emma, is this something that your clients are asking you about quite a lot at the moment?
- Emma** Absolutely. I think whilst, as you flagged, the number of ELTIFs out there actually is pretty low – historically I don't think our clients were that interested in them – pretty much every UK asset manager we meet with at the moment wants to discuss ELTIFs and views them as a serious option for their 2023 product pipeline.
- Hilaire** OK; well, I suppose that is very exciting for a lot of the market. Codrina, are there alternatives to the ELTIF route for approaching retail investors with alternative investments or is that kind of the only one at the moment?
- Codrina** No, there are a number of alternatives. In Luxembourg, the Luxembourg Part II UCIs are at the moment a very attractive option used by retail investors to get exposure to alternative strategies. However, to access retail investors outside of Luxembourg managers are reliant on the local placement rules in each jurisdiction, in each European jurisdiction, and those rules can be time-consuming and expensive to meet in many EU jurisdictions. Therefore, the Luxembourg Part II UCIs route has certain disadvantages. However, if the Part II UCIs route will be combined with the new ELTIF regime then the product will become very attractive for retail investors and it will benefit the EU passports.
- Other structures, such as nominee structures that are set up by private banks in order to invest in alternative funds and funds of funds, are also used at the moment.

Hilaire Thank you so much, Codrina, for your insight from a Luxembourg and EU perspective. Moving to the UK, Emma – what are the options for marketing retail funds in the UK post-Brexit?

Emma So you might remember that, immediately post-Brexit, if an EEA fund wanted to market to retail investors in the UK, the only route available – other than setting up a UK authorised fund – was by becoming a recognised fund under section 272 of the FSMA regime, a route which had historically been little used and was generally considered to be lengthy and onerous, with no guarantee of success. Following successful lobbying by the asset management industry, the UK has launched the Overseas Fund Regime (the "OFR"), which came into force on 22 February this year and is intended to offer a 'fit-for-purpose' alternative. Whilst technically in force, note the FCA is still working on "operationalising the OFR", so it's not quite ready to be used in practice yet.

Hilaire Just going back to you, Codrina, very quickly. Do you think that the OFR would be attractive to EU fund managers who are trying to market in the UK?

Codrina Yes, indeed; once the OFR regime will become operational certain Luxembourg investment funds, such as Part II UCIs that I mentioned before, will be able to use it in order to get access to UK retail investors.

Hilaire And, Emma, so this OFR: how exactly does it work?

Emma So under this regime the Treasury can approve specific countries and then specific types of collective investment schemes from those countries as being "equivalent", and to do this the Treasury needs to be sufficiently comfortable that investor protections are equivalent to those in the UK and there need to be the usual supervisory cooperation agreements in place. Once the Treasury has made that decision, an operator can apply for the recognition of a specific scheme. So, for example, once Irish UCITS are approved as a country, and UCITS are approved as a specified scheme, the ManCo of any individual Irish UCITS could apply for recognition.

Hilaire Does this mean the end of the section 272 regime?

Emma So it means that we are going to have two parallel regimes. Whilst funds which fall within the OFR have to use this regime and can't apply for section 272 recognition, the section 272 route will continue to be available for individual retail schemes not eligible to be recognised through the OFR.

Hilaire OK. Will overseas funds that are falling in the OFR...will they be subject to FCA supervision?

Emma So the FCA won't act as a supervisory body but it will have powers of enquiry to ensure such funds are adhering to UK law and regulation, and it is worth noting there are some additional UK rules that will apply. The FCA won't act as a supervisory body but it will have powers of enquiry to ensure such funds are adhering to UK law and regulation. Note that there are some additional UK rules that will apply to schemes using the OFR.

Hilaire OK, so on these additional UK rules...and while on the topic of the UK, obviously Brexit is still something that we are talking about a lot, where do you think – and this is quite a big question – where do you think the UK is post-Brexit?

Emma So you might recall that when Brexit happened the UK effectively onshored all of the body of EU legislation and so, from a legal and regulatory perspective, very little has changed in the UK: the EU onshored legislation still dominates the UK regulatory environment. However, it looks as if this may be about to change – the Financial Services and Markets Bill earlier this year is intended to kick-start the exercise of creating a domestic framework rather than the one comprising legacy EU law, and as part of that exercise has opened the box to consider changes which could be made to the UK framework to make the UK more competitive.

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- Hilaire** So what does this mean for the concept of equivalence? Is that off the table now?
- Emma** So I think, yes, there is definitely a clear shift of focus from preserving the conditions in the UK so that equivalence could be on the table to this new goal of making the UK more competitive. It's worth noting that when we talk about making the UK more competitive, we are talking about doing so whilst still ensuring strong investor protection, and there is no plan to move to a Singapore-on-Thames with light touch regulation. When we start thinking about the nature of these changes it feels as if the scale of these is going to be more along the lines of removing certain requirements and making tweaks here and there, rather than a full wholesale rewrite of the UK regulatory system. From speaking to managers, whilst there is certainly enthusiasm for launching new products to fill gaps in the market and removing specific parts of the existing regime which are viewed as being unduly restrictive, there is little appetite otherwise for implementing an entirely new regime.
- Hilaire** So you mentioned Singapore-on-Thames, which we have heard a lot about as speculation, and obviously it's not the right plan at the moment for the UK, but how otherwise can the UK become more competitive?
- Emma** So I think it is fair to say at the moment it's a work in progress and it's in the early stages. The Financial Services and Markets Bill is still working its way through parliament, so there is nothing imminent that I can flag to you today. However, it's worth noting that the seeds for this exercise were sown quite a while ago – for example, in our sector, the asset management industry, the Treasury's Asset Management Taskforce was set up in late 2017 with the objective of creating a thriving asset management industry, and this has ultimately led to a review of the UK funds regime, which concluded in February of this year. The next steps from this are a focus on ensuring the tax efficiency of UK structures – the first bits we are starting to see already, with the kind of new quack regime and changes to [rep] regimes – and also working to explore options for the introduction of a new unauthorised contractual fund scheme aimed at professional investors. However, these all looked more at the aspects of what new products can we launch because, rather unhelpfully, at the time of the call for input, it was outside the scope of that exercise to consider what changes could be made to the existing UK regulatory framework, so that paper doesn't consider what we could be doing in changing all of that onshored EU legislation.
- Hilaire** And I suppose the EU is also looking at how to be competitive. Codrina, if I could just ask you quickly, is there a similar drive to be competitive that is being felt in the EU?
- Codrina** Certainly. There is a lot more dialogue at industry level and between the industry bodies in order to get a competitive product at EU level. Therefore there is, as I mentioned already, the ELTIF reform but also IFMD reform that is currently ongoing.
- Hilaire** And, Emma, has the UK proposed any retail regimes that are similar to the ELTIF?
- Emma** So, in November 2021, the UK authorised the "long term asset" fund, which provides an authorised open-ended fund structure to enable investment in long-term illiquid assets whilst offering appropriate structural safeguards. Originally this was limited to professional investors and high net worth individuals but the FCA have published a further consultation paper earlier this year proposing changes to the initial rules and, in particular, these look at broadening retail access. A final policy statement is expected on this in early 2023, and so I think here we are seeing a very similar pattern to what is being seen with ELTIFs and broadening out the ability and the use of those in the retail sector.

- Hilaire** And staying with the UK for a bit longer, the other topic that a lot of people, certainly our clients, are talking about, is ESG – where is the UK now on ESG?
- Emma** So in exciting developments the long-awaited UK Sustainability Disclosure Requirements, the "SDR", is finally on its way!
- Hilaire** OK, so it is finally here; it is very exciting. What exactly is the timing for this?
- Emma** So the consultation paper published by the FCA a few weeks ago sets out the core elements of the SDR, and this will be initially applying to UK asset managers in relation to UK-based funds and portfolio management, and there is a view to expanding their scope in the future. The FCA will be collecting responses until 23 January 2023 and expects to publish final rules by the end of the first half of 2023. It is expected that these rules won't come into effect until June 2024, so there is still a little bit of a journey to go.
- Hilaire** OK, so we have these two regulations sitting side by side, so we have the UK SDR and the EU SFDR. So how do they compare to each other?
- Emma** So I think, as expected by most managers, whilst there are significant similarities there are also very clear differences, and fund managers marketing products into each of the jurisdictions need to prepare for the fact that there won't be harmonised disclosures. I think, to pick up an example, if we look at the labelling, SFDR picks up on the 'Article 6', 'Article 8' and 'Article 9' terminology; well, we can really see how the UK has built on the SFDR and what has been learnt from that implementation exercise and it has proposed a clearer classification and labelling system. We have 'Sustainable Focus', 'Sustainable Improvers', 'Sustainable Impact' and 'No Sustainable Label'. I think to draw this out slightly because "Sustainable Improvers" is quite an interesting category, because it is designed to address the question that came up a lot in SFDR implementation exercises of how do you categorise a fund that looks to buy products that are currently not very environmentally friendly but ultimately turn them into being much more environmentally friendly? So this is a really positive impact and it is good to see the kind of learning and developing that has been going on. In relation to the actual content of disclosures, this bit hasn't yet been made available and, as with the EU SFDR implementation, this is likely to contain the critical detail.
- Hilaire** And so, Codrina, so Emma has mentioned how the UK SDR is building on the EU SFDR and maybe making things more streamlined and applicable to market; from the point of the EU SFDR, is there anything in the pipeline in relation to that regulation?
- Codrina** Yes, indeed. The market is very busy at the moment on completing the pre-contractual disclosure RTS by 31 December 2022 for unregulated funds, and the regulated funds are in the process of liaising with the Lux regulator, the CSFF, in the context of the fast track process that expired on 31 October 2022. So the market and we are very busy at the moment with those updates. Maybe another trend that we should mention is that the market orients itself towards Article 8 and 8+ classification for the funds and this will clearly continue.
- Hilaire** Thank you so much, Emma and Codrina, for joining us and for your insights, and thank you all for listening. For those who would like to find out more about proposed regulatory changes for funds and asset managers, please go to the Allen & Overy website in the Asset Management and Funds section where further material can be found.